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ABSTRACT

Considerable resources have been spent to rescue a few countries from crises caused by dramatic shifts in financial inflows and outflows. Measures should be sought to render the institutions and mechanisms of international financial transactions more transparent, accountable, and supportive of the delicate balance between short-term stability and long-term structural change. This issue takes a critical look at the existing financial architecture, highlighting some of its shortfalls, and proposing measures for the intricate task of designing a new financial architecture at global, regional, and national levels. This issue begins with a foreword from the editor, "From Emergency Bail-outs, to Sustainable Growth." The first section of this issue, Institutions and Practices, includes the following articles: "Towards a New International Financial Architecture" (United Nations Executive Committee on Economic and Social Affairs); "The International Monetary Fund: A Cure or a Curse?" (Devesh Kapur); and "Borrowers, Lenders and the Asian Financial Crisis: The 'Moral Hazard'" (Aziz Ali Mohammed). The next section, Regional Issues, contains: "Policy Instruments for the Return of Private Capital to Asian Countries" (Roberto F. De Ocampo); "Managing Foreign Capital Flows in Chile" (Martin Khor and Lean Ka-Min); and "Globalization of Finance and Development Prospects in Africa" (Nguyuru Lipumba). The final section, Windows on the South: Current Trends, Perspectives, and Events, includes: "New UNDP Administrator and Associate Administrator Named"; "Business and Investment Collaboration Being Mapped between Africa and Asia"; and "A Wind-Up Radio for the Poor." (BT)

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Rethinking the International Financial System: Views from the South

Yiping Zhou, Editor

Cooperation South n1 Jun 1999

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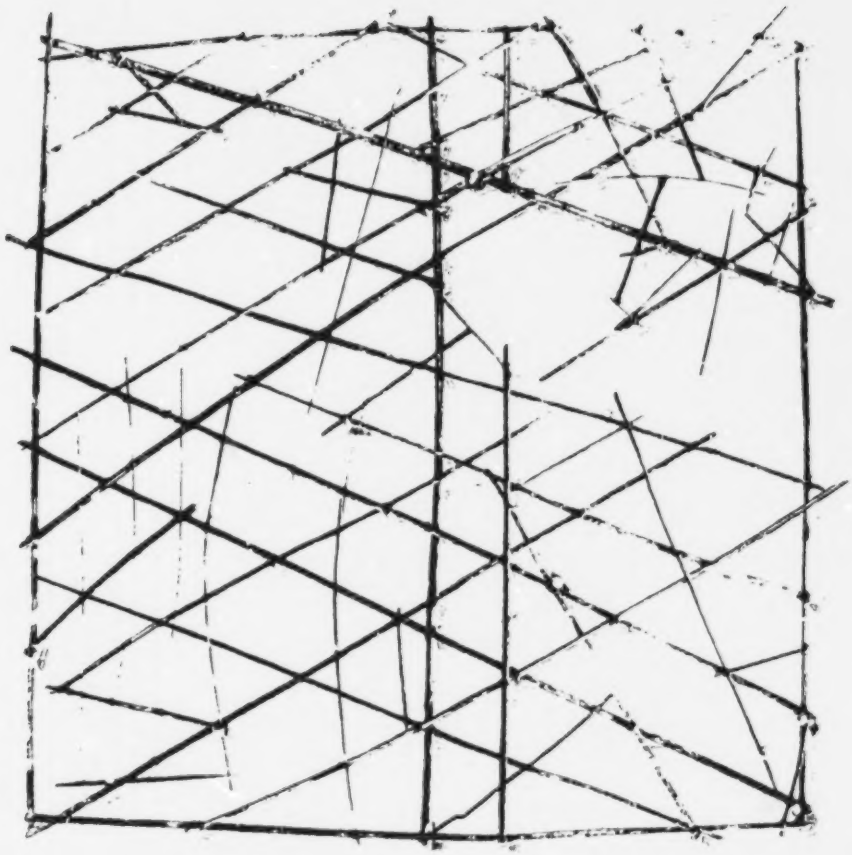


RETHINKING THE INTERNATIONAL FINANCIAL SYSTEM

Views from the South:

- **ARCHITECTURE AND POLICIES**
- **RISKS AND POTENTIALS**

NUMBER ONE
JUNE 1999

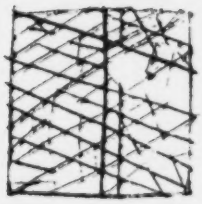
3

UNITED NATIONS DEVELOPMENT PROGRAMME
SPECIAL UNIT FOR TECHNICAL COOPERATION AMONG DEVELOPING COUNTRIES

THE CREATIVITY OF 4.7 BILLION PEOPLE

THE COVER DESIGNS USED ON ISSUES OF THIS JOURNAL PRESENT ARTIFACTS OR ARTWORKS THAT DEMONSTRATE THE CREATIVITY AND CONNECTIVITY OF PEOPLE ACROSS THE SOUTH.

Navigating in the Western Pacific



As first reported in 1862, for several centuries the people of the Marshall Islands have created stick and shell charts for navigating the waters of the western Pacific Ocean. The charts are made from lengths of palm fibre, tied together by threads of coconut fibre. Straight or curved, these "sticks" point in various directions to show the directions of deep-sea swells and currents. Small sea shells representing islands are attached at the intersections.

To use these maps, islanders spread them on the decks of their boats and kept constant the angle formed by the deck and the direction of the prevailing wave crests, which can be seen for up to 15 miles. A squadron of 15 or more canoes would sail in company under the leadership of a pilot skilled in the use of the charts. They could navigate seemingly featureless waters over several hundred nautical miles.

The islanders observed and charted the precise currents and swells for hundreds of years. The patterns they mapped have been confirmed since 1970 when NASA satellite surveys began intensive coverage of the ocean surface.

Cooperation South

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The emblem of Technical Cooperation among Developing Countries (TCDC) displays a symbolic bridge joining the countries and people of the Southern hemisphere.

The centre of the emblem—where the Southern, Northern, Eastern and Western parts of the world join—symbolizes a further and ultimate objective of TCDC: the promotion of a truly global partnership for development.

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FROM THE ADMINISTRATOR

THIS ISSUE OF *COOPERATION SOUTH* is a timely appraisal of the international financial system. The recent turmoil in international financial markets exemplifies the costs of an increasingly integrated international capital market. The World Employment Report warns that the number of unemployed and underemployed workers around the world has never been higher, and will grow by millions more before the end of the year, as a result of the financial crisis in Asia and other parts of the world. Similarly, World Bank estimates indicate that the number of poor people in East Asia will increase sharply in the next two years, from 40 million to more than 100 million. In Indonesia alone, the number of people living on less than $ 1 a day will jump from 13 million in 1997 to 34 million in 1999. Such growing patterns of unemployment, declining income, and increasing poverty widen inequalities and trigger social unrest. Instances of sporadic rioting and looting witnessed in parts of East Asia, along with attacks on ethnic minorities show that a financial crisis can have adverse effects on a country's social and political fabric. The crisis further demonstrates the real danger of creating a huge global underclass which will undermine international stability.

Even before the international financial crisis cut the global growth rate in half and plunged more than a third of the world's economies into recession, the data on poverty showed alarming disparities between the poor and the rich. In the past 15 years, per capita income has declined in more than 100 countries, and individual consumption has dropped by about one per cent annually in more than 60 countries. Meanwhile, some 150 million people — equal to the combined populations of France, the United Kingdom, the Netherlands, and the Nordic countries — were pushed into poverty when the Soviet Union collapsed.

Among the 4.4 billion people in developing countries around the world, three-fifths live in communities lacking basic sanitation; one-third go without safe drinking water; one-quarter lack adequate housing; one-fifth are undernourished; and 1.3 billion live on less than $1 a day. Nearly one-third of the people in the poorest countries, mostly in sub-Saharan Africa, can expect to die by age 40.

Put together, these developments indicate that turbulence in financial markets is only a symptom of more profound deficiencies in the international economic system. It is therefore timely to rethink the assumptions that as markets are integrated, as investments flow more easily, and as competition is enhanced, living standards everywhere will improve. The clear lesson of the past five decades is that economic growth, though essential, is by no means sufficient to eliminate severe poverty or bring about

lasting development. True development requires profound institutional changes that empower poor people to contribute to and benefit from the economy. It entails investing in the human, social, environmental, and physical assets of the poor, expanding their access to productive resources, social services, and basic infrastructure. It demands changes that promote the advancement and empowerment of women and other marginalized groups. And it should be built on good governance and strengthened national capacities in the public, private, and nongovernmental organization sectors. But right at this confluence of greater need and greater opportunity, resources for long-term development are declining.

Development assistance has declined for five years running and is now at a historic low. If this trend is not reversed, it could cost dearly later — not just in missed economic opportunities, but in emergency relief, peacekeeping forces, the spread of disease, environmental deterioration, illegal immigration, refugees, and terrorism. The West should sharply increase its total assistance now in order to help Asia without neglecting Africa; it would be in its own best interests to do so. Development assistance is not an alternative to private investment, but an essential building block for a vibrant private sector and successful financial markets. It is not a handout, but rather a solid investment in peace and a more equitable and habitable world.

A new framework for such aid must switch the focus of scarce funds to the most pressing needs of people, particularly the poor. The scope of development cooperation must broaden to include not only assistance but trade, debt management, private investment and capital flows, access to technology, and the strengthening of civil society as a whole. In particular, it must correct the chronic underinvestment in social programs by poor countries with unshoulderable debt burdens. To make this possible, the international community must provide full relief of these countries' external debt burden.

James Gustave Speth

James Gustave Speth, Administrator
United Nations Development Programme

EDITOR'S FOREWORD

From Emergency Bail-outs, to Sustainable Growth

CONSIDERABLE RESOURCES have been spent to rescue a few countries from crises caused by dramatic shifts in financial inflows and outflows. The financial crisis in a relatively small number of countries masks the more acute, if low-intensity structural crisis of most developing countries over the last twenty years. Beyond bailing out troubled emerging markets, the international community needs to explore ways of ensuring that the rapidly expanding financial resources in some parts of the world are put to work for sustainable development, globally. To that end, measures should be sought to render the institutions and mechanisms of international financial transactions more transparent, accountable and supportive of the delicate balance between short-term stability and long-term structural change.

This issue of *Cooperation South* takes a critical look at the existing financial architecture, highlighting some of its shortfalls and proposing measures for the intricate task of designing a new financial architecture at global, regional and national levels.

INTERNATIONAL DIMENSIONS

Our first article looks at the boom-bust pattern in international financial transactions, the contagious nature of financial crises, the dangers posed by premature and hasty capital account liberalization, and the social cost to developing countries servicing high foreign debts. Conclusion: the existing financial system needs serious reform. Proof: existing institutions are inadequate to deal with current trends of financial globalization, as shown by financial crises since 1997 and their precedents in the 1980s and 1990s. The article, produced by the United Nations Executive Committee on Economic and Social Affairs, recommends changing the system to make it more capable of preventing future crises and more effective in managing crises when they occur.

The report calls for an approach that considers the financial architecture as an organic whole. Issues requiring particular attention include international liquidity management, global consistency in macroeconomic policies and financial regulation, international financing for development, and the resolution of outstanding debt issues. Among its suggestions are IMF reform to provide adequate international liquidity in times of crisis; adoption of codes of conduct, improved information, and financial supervision and regulation at national levels; preservation of the autonomy of developing and transition

economies with regard to capital account issues; incorporation of internationally sanctioned standstill provisions into international lending; and design of a network of regional and subregional organizations for managing monetary and financial issues.

Devesh Kapur asks whether the International Monetary Fund (IMF) is a cure or curse, and argues that IMF policy diagnoses and prescriptions have been badly misdirected for many years. Since IMF's predictions about Asia were so wrong — praising Asia's fundamentals in summer 1997 and then decrying them a few months later — why should its prescriptions be any better, he wonders. Kapur notes that the IMF's engagement with industrialized countries had become largely proforma since the collapse of the Bretton Woods system in 1971. Considering the Fund's record since then, he contends that its African programme in the late 70s proved "singularly ill-advised", given the continent's deep-rooted political and social problems. On the other hand, the IMF was significantly helpful in Asian countries with viable institutional infrastructures.

From the early 80s, with the advent of the Latin American debt crisis, the IMF reinvented itself, becoming the creditor community's enforcer with an expanded mandate to promote structural reforms. In light of the Fund's record on the Mexican and Asian crises, Kapur endorses views now shared by many analysts. First, financial flows should be regulated in some way. Second, developing countries need to open up to the world's capital markets, but at a pace commensurate with their capacity to develop sound regulatory and institutional structures, including limits to short-term foreign borrowing. Third, to deal with crises when they occur, an international equivalent of domestic bankruptcy codes should be established for creditors and debtors to resolve their differences.

In his analysis of the international practices underlying the Asian financial crisis, Aziz Ali Mohammed discovers that faulty assumptions by lenders and borrowers diminished precautions to prevent the crash. Most debtors failed to hedge the risk of borrowing in foreign currencies, wrongly assuming that authorities held ample foreign exchange reserves to defend against speculative attack. Financial interventions by authorities led to a false sense of security as private financial intermediaries conducted high-risk operations. Also, investors counted on being bailed out by IMF as was the case in the Mexico financial crisis of 1994.

NATIONAL AND REGIONAL DIMENSIONS

In addition to examining international institutions and practices, this issue focuses on national and regional dimensions of the financial system. Roberto Ocampo provides an on-the-ground perspective regarding the policy initiatives, broad changes and deep reforms needed for the return of private capital flows to Asian countries. Optimistic about Asia's prospects to restore balance and regain investors' confidence, he notes that since the crisis basically started as a problem of liquidity, recovery requires inter-

national support to infuse sufficient liquidity in distressed economies, enabling them to concentrate on reform. Also needed are global mechanisms to monitor international capital flows. He recommends a new Asian development model with a more active role for civil society, innovative forms of public/private partnership, and strengthened financial systems to facilitate capital account liberalization backed by improved supervision, prudential regulation of financial markets, and efforts to deepen and broaden capital markets. The urgent task for decision-makers and policy-makers is to restore growth to their respective economies and to the region as a whole.

To this end, Ocampo says the paramount long-term challenge for Asia is to build the region's social "software", rather than focusing solely on fiscal regulation, macroeconomic stability or exchange rate management. Asia's flawed social infrastructure and inadequate political institutions allow too much corruption and mismanagement. To restore confidence in international markets, he maintains that investors will need to see effective leadership, clear policy directions, strong determination to pursue reform, more openness to change and to greater interdependence and integration, a commitment to open management, and far-reaching social development.

Martin Khor and Lean Ka-Min present Chile's policies for managing foreign capital flows as a possible model for other developing countries to follow. Essentially, Chile has adopted measures to prevent excessive capital movements that could damage the economy, build up foreign debts, channel funds into unproductive investment and risk a debt crisis. Included are regulatory mechanisms to curb national expenditure, keep inflation in check, maintain relative price stability and promote export-led growth. The authors acknowledge that the country's success in attracting investments from abroad to finance economic development can wreak havoc on the domestic economy. They emphasize, however, that Chile's approach is innovative and instructive for it sifts out less desirable components of foreign capital and provides incentives to encourage the inflow of long-term productive investments.

Worthy of note in Chile's approach to the moderation of exchange rate appreciation commonly caused by an influx of new capital, is the use of several strategic instruments that are mutually reinforcing. Particularly significant is the application of taxes and reserve requirements on short-term capital inflows. This policy regime is moving Chile's external financing away from debt to direct investment and equity-based portfolio investment, and away from short-term financing to a larger share of medium and long-term borrowing.

In Sub-Saharan Africa, most countries have been bypassed by the surge in private capital inflows to developing countries during the 1990s. What national-level reforms and international initiatives would help them mobilize needed domestic and external investment? In answering this question, Nguyuru H. I. Lipumba observes that despite adopting market-friendly policies, most Sub-Saharan countries have been bypassed by

the surge in private capital flows to developing countries during the 1990s. A major hindrance to foreign investment on the continent is that most African countries face large external debt payments. Compounding this predicament are low saving rates, declines in official development assistance, and IMF-prescribed adjustment programmes for some countries which have reduced public investment without increasing private investment. But to increase and sustain poverty-reducing growth, these countries need more and better investment in physical, institutional and human infrastructure. Only three countries have significant access to external commercial bank loans, and only six have equity markets that attract portfolio investment. Because of large arrears on debt payments, most lack credit-worthiness and have no access to funds, such as long-term syndicated bank loans, that could be used for infrastructural investments.

Lipumba recommends that African countries design policies that foster macroeconomic stability, build institutional capability in government, maintain transparent rules of the game and provide incentives for private sector investment. Current democratization processes open the opportunity for elected governments to take bold measures to these ends. Internationally, since private markets are less likely to meet Africa's finance needs, he favors increased funding for international development financial institutions, special World Bank subsidies on interest payments, and access to finance in private capital markets through Bank mediation. Lipumba stresses, however, that development is a "do-it-yourself" process. External capital flows, foreign ideas and technology transfers are of complementary importance, but the real engine of Africa's development must consist in domestic effort to understand, adapt and manage development policy.

INVITATION TO PROBLEM-SOLVING

This issue of *Cooperation South* does not try to develop a blueprint of what a reshaped international financial architecture should look like. Rather, it provides a platform for some key designers, managers, users, beneficiaries and observers of the system to diagnose some of its problems, and to contribute to the important debate about ways of overcoming them.

We invite our readers to join the search — in their home settings and institutions, in their South-South or South-North roles, and in our columns. There are no easy or automatic solutions. Some of the issues are immensely complex, combining questions of global market behaviours, with national and regional concerns about sustainable growth, economic development and social equity. There is perhaps no item on the international agenda with as much urgency and as much relevance to so many people in so many parts of the world.

John F.E. Ohiorhenuan

Towards a New International Financial Architecture[1]

How to safeguard the world economy from financial crises and contagions?

It takes some rethinking — if not some rebuilding — of the complex and inadequate international arrangements now in place. Developing countries and transition economies have the most to lose if this is not done, and protection for the poor during crises is still more a matter of rhetoric than practice. Detailed technical suggestions for this needed new "architecture" have now been presented in the following report, prepared by a group of UN staff specialists.

THE INTERNATIONAL FINANCIAL CRISIS AND THE NEED FOR REFORM

World events since mid-1997, and their precedents in the 1980s and 1990s, have made painfully clear that the current international financial system is unable to safeguard the world economy from financial crises of high intensity, great frequency and devastating real effects. The rapid spread of the current international financial crisis, from east and southeast Asia to other developing and transition economies, and even to the industrialized world, has already led to statements and decisions by the authorities of developed countries, who recognize that it is indeed the most threatening event of its kind in more than half a century. The threat is reflected in the successive substantial downward revisions of forecasts of world economic growth in the last year and a half. The crisis reflects two underlying issues:

First, the tendency of financial markets to experience sharp boom-bust cycles. During financial booms, lenders and borrowers underestimate the risks involved in high levels of indebtedness, a fact that only becomes apparent, with particular severity, during the ensuing downswings and panics. This volatility is inherent in the functioning of financial markets. It reflects not only imperfections in the flow of information, but also radical changes in its interpretation and sharp revisions in expectations as new information arrives, shifts that can be severe because of the uncertainty intrinsic to the intertemporal decisions that underlie financial transactions. The liberalization of financial flows among industrialized and some develop-

[1] For background to this paper, see explanatory note on page 24.

ing countries, floating exchange rates, financial innovations and new communications techniques have increased not only financial transactions, but also volatility in recent decades.

Second, the crisis has also demonstrated, with particular severity on this occasion, that financial crises are contagious; that under panic conditions markets do not adequately discriminate between countries with strong and weak economic fundamentals; and thus that crises tend to spread even to countries with sound economic structures and macroeconomic management. The concentration of participants in international financial markets that apply criteria indiscriminately to all countries is a major basis for contagion. In many cases, financial crises spread because highly leveraged investors, faced with losses in one market and ensuing margin calls, sell good assets in another country; investment banks and mutual funds may also engage in similar behaviour in order to raise liquidity in expectation of withdrawals by clients.

Developing and transition economies have been highly vulnerable to financial volatility and contagion. They have been particularly prone to periods of rapid expansion and diversification of financial flows, often followed by abrupt reversals. This pattern has been aggravated by premature and hasty liberalization of the capital account, fragile domestic financial structures, and weak financial regulation and supervision. Extended financial booms build up strong pressures on aggregate domestic demand, which make macroeconomic balances unsustainable during the ensuing financial contraction. They also tend to weaken financial structures, as increasing risks are often underestimated. Under these conditions, the downswing may result in domestic financial crisis, which consumes large amounts of the scarce resources available to development, and severely affects economic activity and investment for several years. The impact of financial crises on the real economy is thus far larger than in developed market economies.

Developing and transition economies have been highly vulnerable to financial volatility and contagion.

External debt and domestic financial crises generate, in turn, substantial social costs. As it happens, poor sectors of society pay a substantial share of the costs of adjustment to debt crises, whereas they benefit rather marginally from financial booms. These costs also tend to fall disproportionately on women and children. The experience of many developing countries in several regions of the world also indicates that the social effects of debt crises continue to afflict countries even after several years of successful economic restructuring and recovery. The Latin American experience since the

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early 1980s is particularly relevant in this regard. Preliminary evidence suggests that a similar pattern may occur in the east and southeast Asian nations.

Lastly, the recent crisis has demonstrated a fundamental problem in the global economy: *the enormous discrepancy that exists between an increasingly sophisticated and dynamic international financial world, with rapid globalization of financial portfolios, and the lack of a proper institutional framework to regulate it.* In brief, existing institutions are inadequate to deal with financial globalization. This is true of institutions at the international level, which have manifested significant shortcomings in the consistency of macroeconomic policies, and in the management of international liquidity, financial supervision and regulation. It is also true of national institutions in the face of globalization, even in industrial countries. This systemic deficiency and the associated threat of recurring crises in the future have thus underscored the need for a comprehensive reform of the international financial system, geared to prevent costly crises and to manage them better if they occur. The outcome would improve economic and social prospects worldwide.

THE NEED FOR IMMEDIATE ACTION

In order to prevent the current crisis from deepening, immediate actions are required from the major industrial countries and from the international community. There is evidence that the world economy is experiencing a major slowdown, which may deepen if inadequately managed. Japan is in its worst recession since the war, much of east and southeast Asia is in depression, Russia is experiencing a major downturn, growth has stalled in Latin America, and the prices of primary commodities and a number of manufactures are falling in international markets. We therefore embrace the declaration of the Group of Seven on the need to confront the threat of world recession, and we applaud the decisions by the central banks of the United States and Western Europe to reduce interest rates in recent months, the important fiscal stimulus announced by Japan and its decision to face up to its domestic financial crisis. Authorities in the industrial countries must nonetheless continue to be alert. Several downside risks still remain, and current policies may prove insufficient to prevent the world economy from slipping into recession. Expansionary fiscal policies may thus be required in other industrial economies, in addition to Japan. It is also crucial that the rules of an open international trading system should operate smoothly, allowing the

Existing institutions, both international and national, are inadequate to deal with financial globalization, even in industrial countries.

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economies that face adjustment to reduce their deficits or generate trade surpluses with the more vigorous industrial economies.

With the full support of the international community, IMF should put together contingency funds to assist countries now experiencing crisis or contagion and others that could become the victims of world financial crisis in the future. These include countries that may be affected indirectly by the effects of such crises on trade and commodity prices, particularly low-income African and Asian countries. We therefore welcome the recent declaration and actions by the Group of Seven to guarantee adequate contingency financing, by completing the implementation of the IMF quota increase and the New Arrangements to Borrow, and the commitment to supplement the Fund's resources when necessary. Moreover, as we argue below, it is essential that this new type of contingency financing, which is to be made available *before* international reserves are depleted, should become a stable feature of the new international financial order, and that the availability of funds should be guaranteed without delay when needed. Developing and transition countries experiencing difficulties must obviously be ready to adopt the necessary adjustment policies, as they have by and large been doing during the recent crisis. Rescue packages and, more generally, adjustment policies, should give special emphasis to a fair and progressive sharing of the costs of adjustment. The design of gender-equitable social safety nets is necessary, in particular, to ensure that this burden does not fall disproportionately on the poor and on women.

REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

In the longer term, fundamental reforms of the international financial architecture are needed. The international financial system is an organic whole and requires a comprehensive approach. Reform must therefore encompass a number of interrelated aspects of international liquidity management, global consistency of macroeconomic policies and financial regulation, areas essential to the prevention and management of financial crises, as well as finance for development and the resolution of outstanding debt issues. This report addresses international monetary and financial issues in the first group, but some suggestions on broader and related issues are also provided.

With regard to the first group of issues, it must be emphasized that the present system is badly equipped to prevent financial crises and only partly equipped to manage them. Reforms in this area must be addressed with a sense of urgency in six key areas:

- Improved consistency of macroeconomic policies at the global level;
- Reform of the IMF aimed at providing adequate international liquidity in times of crisis;

- The adoption of codes of conduct, improved information, and financial supervision and regulation at national and international levels;
- The preservation of the autonomy of developing and transition economies with regard to capital account issues;
- The incorporation of internationally sanctioned standstill provisions into international lending; and
- The design of a network of regional and subregional organizations to support the management of monetary and financial issues.

It is important to underscore the interrelated character of these reforms. Indeed, it is clear that reliance on any one or a few of these proposals would not generate a balanced world system, able to prevent and manage crises or ensure equitable participation by all members of the international community.

We must emphasize that any reform of the international financial system ought to be based on a broad discussion, involving all countries, and a clear agenda, including all key issues. The process must ensure that the interests of all groups of developing and transition economies, including poor and small countries, are adequately represented. The United Nations, as a universal and the most democratic international forum, should play an important role in these discussions and in the design of the new system.

Any reform of the international financial system must ensure that the interests of all developing and transition economies, including poor and small countries, are adequately represented.

IMPROVING THE CONSISTENCY OF MACROECONOMIC POLICIES AT THE GLOBAL LEVEL

The crisis has made evident the need to enhance the coherence of macroeconomic policies in industrial countries, in order to avoid both inflationary and deflationary biases at the global level. The design of international institutions and policies must include clear incentives for national authorities in the industrialized world to maintain their economies at close to full employment while at the same time avoiding inflation. This will have favourable effects, not only for these economies, but also for the world at large. It must be emphasized that consistency in this sense should be primarily aimed at ensuring the global coherence of a set of interrelated national policies, rather than the adoption of identical decisions, since, in fact, inflationary or deflationary pressures will not necessarily be uniform at a given time. In order to achieve this objective, a more effective surveillance of national policies by IMF and regional and subregional institutions is necessary.

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This surveillance must have broad objectives and a preventive character, acting to warn of impending unemployment and growth retardation, as well as of inflationary pressures reflected in the evolution of domestic prices of goods, services and assets or in the deterioration of external balances.

The most appropriate institution or set of institutions to ensure such consistency should be subject to debate. Proposals include granting greater policy powers to the IMF Interim Committee, and broadening the Group of Seven to include representatives of the developing and transition countries. The nature of the relative power relations that underlie these organs should be part of the debate. Hence, these proposals should be seen as consistent with the need to strengthen the Economic and Social Council, as indicated in the Report of the Secretary-General, "Renewing the United Nations: A Programme of Reform", to provide political leadership and promote broad consensus on international economic issues. The necessarily broader mandates of this Council would then have to be harmonized with those of the specific body in charge of macroeconomic policy consistency. As argued below, a set of regional institutions should also be brought into play, aimed at achieving macroeconomic coordination and a more balanced world order.

Macroeconomic policies, including decisions by central banks, should be subject to public scrutiny, aimed at ensuring proper balance between their multiple objectives (particularly between employment/growth objectives and inflation/balance-of-payments objectives). For the same reasons, IMF should be also subject to public scrutiny on similar grounds, with effective independent evaluations leading to accountable and pragmatic improvements in policy approaches.

THE PROVISION OF ADEQUATE INTERNATIONAL LIQUIDITY IN TIMES OF CRISIS

The management of international liquidity has a special role in preventing and avoiding contagion from financial crises and lessening their adverse economic effects. Whereas these objectives could eventually be best pursued through the creation of a true international "lender of last resort" (i.e., a world central bank), conditions are not ripe for such a bold reform to existing institutional arrangements. It would require, in particular, the surrender of more economic autonomy and powers of intervention in national policies than countries are willing to accept at present. Nonetheless, much can be done to improve the way IMF operates so that, in effect, it moves in that direction. Today, IMF has inadequate funds; it acts more as an organizer of rescues than as a provider of funds; the conditions attached to the use of its funds are not always appropriate to the problems faced by countries in distress; and it has very limited capacity to stop contagion.

Still, the Fund could do much to stem the spread of financial crises. In the first

place, where the problem of contagion derives from reduced export demand and prices, it has the authority to make low-conditionality loans through the Compensatory and Contingency Financing Facility (CCFF). The facility should be used more actively, and more resources relative to country quotas should be provided under it. However, the bulk of the demands on the Fund in times of crises will come from countries experiencing capital account problems. Therefore, recent contingency financing mechanisms should become the basis for a stable, low-conditionality facility for countries experiencing financial contagion. Countries that meet certain ex ante criteria would be eligible, and eligibility would be examined during Article IV consultations.[2] Low-conditionality funds would then be made available, though at shorter terms and higher interest rates than traditional IMF resources. The corresponding criteria could include indicators such as those associated with current account deficits, the evolution of the exchange rate, the ratio of short-term debt to reserves, and the ratio of short-term and portfolio capital inflows to exports or GDP.

IMF resources should be enlarged in order to enable it to enhance the stability of the international financial system. Three channels can be considered. First, effective and swift mechanisms should be devised to increase its access to official funds in times of crisis. Second, it could be granted authorization to borrow directly from financial markets under those circumstances. Third, and perhaps most important, Special Drawing Rights (SDRs), a form of international liquidity that can be created by the IMF for use mainly in transactions among central banks, could be created when several members face financial difficulties. The SDRs thus created would be destroyed as borrowings were repaid. These mechanisms would facilitate the creation of additional liquidity at times of crises, without the painstaking negotiations of quota increases or arrangements to borrow. Moreover, current arrangements to borrow exhibit the shortcoming that they are activated only under systemic threat and after the approval of the suppliers of funds, with the corresponding delays in making new funds available to the Fund and the countries in distress. Indeed, the anticyclical use of SDRs to manage financial cycles should be part of a broader process aimed at enhancing their use as an appropriate international currency for a globalized world.

Conditionality should not apply to development strategies and institutions, which by nature should be decided by national authorities, based on broad social consensus.

IMF conditionality is legitimate for drawings that are made when a country is

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experiencing balance-of-payments problems originating in inappropriate macroeconomic policies, or for the use of funds greater than the automatic low-conditionality facilities mentioned above, when facing either an externally induced current or capital account crisis. However, IMF should restrict itself to the macroeconomic issues that fell within the purview of conditionality in the past. When domestic financial regulation and supervision are deemed inadequate, it could also recommend (or require) a parallel agreement with the international authorities in that area (see below). Conditionality should not include issues related to economic and social development strategies and institutions, which, by their very nature, should be decided by legitimate national authorities, based on broad social consensus. Indeed, the imposition, under crisis conditions, of structural and institutional changes that do not fit the national situation or the

WHEN COUNTRIES SEEK TO CONTROL THEIR EXCHANGE RATES, they often "peg" them to another currency, commonly the United States dollar, or an index of currencies in some fixed proportion (a "basket"). The most extreme form of peg is the currency board, where the board in effect backs each unit of the domestic currency with a fixed amount of foreign currency and stands ready to see the domestic money supply shrink by whatever is required should there be a net exit of foreign funds (and vice versa for a net inflow). In the typical peg system, the central bank buys or sells foreign exchange as needed (and/or administratively controls access to foreign exchange) in order to keep the price at the official peg. In an "exchange rate band", the exchange rate is allowed to fluctuate, but only within pre-set limits around the peg.

Except in a currency board system, pegs have to be changed from time to time, for example, owing to the accumulated impact on price levels of differences in inflation rates at home and abroad. Instead of a discrete "devaluation" of the exchange rate, a country may adopt a "crawling peg", in which the required adjustment is spread over a period (typically adopted in situations of repeated need for devaluation and thus a fairly continuous process).

At the other extreme, a country may allow its exchange rate to "float freely". However, as that can entail large swings in the exchange rate, owing to the volatility of international financial flows, the government may intervene in the foreign exchange market at moments of its choosing to temporarily slow or change the exchange rate movement, called "dirty floating".

national consensus potentially generates instability — economic and political, national and international. It also tends to undermine the international consensus on which the Fund itself is built. Nor should conditionality cover areas within the purview of other international institutions and agreements, such as the World Trade Organization (WTO). Inasmuch as the Fund currently has no mandate with respect to capital account convertibility — and, as argued below, should not have it in the future with respect to developing and transition economies — convertibility should not become a requirement for access to Fund resources either.

Moreover, conditionality should not be used to force the adoption of a specific exchange rate regime by any country.

Developing and transition economies should retain the right to impose disincentives or controls on inflows, particularly in times of capital surges, and on outflows during severe crises.

The experience of industrial as well as of developing and transition economies in recent decades indicates that a great variety of regimes can be successfully managed under the current world system. They range from currency boards to total exchange rate flexibility, including intermediate regimes such as crawling pegs, exchange rate bands and "dirty" floats.

What should be made clear to national authorities is that the exchange rate regime they adopt should be consistent with fiscal and monetary policies, which vary according to the regime chosen, and that it may require complementary measures. Thus, fixed exchange rate regimes demand a larger amount of international reserves to be viable, and intermediate regimes generally require more active intervention in the management of the capital account. Therefore, it would appear that the best course of action in this regard is a pragmatic one.

Lastly, in order to avoid overkill, the IMF should adopt general practices that allow for automatic reduction of the restrictiveness of an adjustment agreed upon with a borrowing country, if it becomes evident that the contraction of economic activity is greater than originally envisaged in the adjustment programmes.

CODES OF CONDUCT AND IMPROVED SUPERVISION

A basic consensus in current discussions relates to the need for international codes of conduct in the fiscal, monetary and financial areas, for principles of sound corporate governance, for improved accounting standards, for greater availability and transparency of information regarding economic and financial data and policies, and for enhanced financial supervision and regulation. These should include international standards to com-

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bat money and asset laundering as well as corruption and tax evasion. All these initiatives should be consistent with the provisions contained in the main international human rights instruments adopted by the United Nations, particularly in the International Covenant on Economic, Social and Cultural Rights.

These existing and proposed agreements are part of a laudable process, aimed at creating greater transparency in public policies worldwide. They also play an essential role in risk management and crisis prevention. We therefore welcome initiatives by the Fund, the World Bank, the Organisation for Economic Co-operation and Development (OECD), the Bank for International Settlements (BIS), the International Organization of Securities Commissions (IOSCO) and other relevant institutions in these areas.

The role of financial regulation and supervision in risk management and crisis prevention must be particularly emphasized. A central element of a new international financial architecture is the development of regulatory and supervisory mechanisms that will better correspond to today's globalized private capital and credit markets. Such mechanisms should be global in the sense of including all countries (and particularly source countries) as well as different financial institutions and markets, so as to avoid regulatory gaps and asymmetries. However, due account should be taken of different national financial structures and traditions as regards financial regulation and supervision.

The design of minimum standards for financial regulation and supervision should go hand in hand with global regulation. An important proposal in this area is the recommendation to create a world financial authority — or a standing committee for global financial regulation — in charge of setting the necessary international standards for financial regulation and supervision and of supervising their adoption at the national level. Such an institution could evolve from existing ones, such as BIS and IOSCO. This proposal would require significant expansion of the membership of these organizations. Alternative arrangements include strengthening existing institutions with broader membership, peer review and new regional and subregional organizations.

Minimum prudential standards must be designed not only to cover bank transactions but also, in view of the progressive breakdown of the traditional compartmentalization of the financial industry's activities, the new actors in financial markets, including hedge and mutual funds. The Core Principles for Effective Banking Supervision of the Basle Committee on Banking Supervision should be worked out more fully as regards international banking and consolidated supervision; these Principles should urgently be applied as a standard in all countries taking part in cross-border financial transactions. This would go a long way towards preventing systemic risk at the international level and controlling

various risks at the country level. At the same time, an additional reform to be considered is the formulation of standards to prevent restrictive practices and strengthen market integrity in national markets and to foster secure clearance and settlement of the growing volume of international transactions.

In the case of industrial countries, we welcome the Group of Seven declaration of 30 October 1998 on the need to examine "the implications arising from the operations of leveraged international financial organizations including hedge funds and offshore institutions" and "to encourage off-shore centres to comply with internationally agreed standards". In developing and transition countries, the implementation of the Core Principles should go hand in hand with a significant effort to improve domestic regulation and supervision of banks and other financial intermediaries. More broadly, risks related to the growth of credit, to the matching of assets and liabilities as regards both their currency denomination and time profile, and to the valuation of fixed assets as collateral during episodes of asset inflation require careful definitions in line with the Core Principles.

Changes in key macroeconomic variables — interest and exchange rates, in particular — have a large impact on the health of banks, especially in developing and transition countries, where they can fluctuate widely; the unpredictability of these variables needs to be taken into account in devising norms of prudential regulation and supervision. In particular, it suggests that capital adequacy requirements need to be higher in developing and transition economies, and that they should be raised during periods of financial euphoria to take account of the increasing financial risks intermediaries are incurring. Owing to the serious adverse macroeconomic externalities of unhedged exposures of non-financial firms, there is also a good argument for authorities of developing and transition economies to monitor their balance sheets and impose limits or matching requirements on them.

Risk-rating agencies are the main private institutions responsible for providing information to investors. Their performance during recent crises has been unsatisfactory. The inclusion of "subjective" elements in their evaluation of sovereign risks has generated a procyclical pattern of risk evaluation, which has tended to promote, first, excessive investment in developing and transition economies, and then huge and abrupt capital outflows.[3] In this way, instead of attenuating financial cycles — the effect that a good information system should have on markets — they have tended to intensify them. Thus, sovereign risk rating should be subject to strict, objective parameters that are publicly known.

Although transparency in information and improved regulation and supervision are certainly important, they are by no means a fail-safe instrument for preventing financial crises, which can also arise

from macroeconomic and other factors. Moreover, practices in regulation and supervision tend also to lag behind in a world of constant financial innovations, and they themselves may induce innovations. Furthermore, the information problems that supervisors face should not be underestimated. Therefore, any regulatory framework should give considerable weight to banks' and other intermediaries' own *internal* controls and systems of risk management.

It is clear that the principle of transparency of information should also be applied to international institutions, but evidently, different standards should apply to the information generated by these institutions and to their *opinions* on countries' policies.

PRESERVING THE AUTONOMY OF DEVELOPING AND TRANSITION ECONOMIES WITH REGARD TO CAPITAL ACCOUNT ISSUES

Across-the-board liberalization of capital account transactions has been a policy thrust that some developed countries have pursued insistently in recent years in a number of forums, including OECD, WTO and IMF. What they urge is contrary to their own historical experience, which featured long periods of capital controls and very gradual liberalization of their capital accounts in recent decades. Moreover, the current financial crisis has clearly shown that abrupt or premature liberalization of the capital account is inappropriate for developing and transition economies, a fact that is now generally recognized. Strong domestic financial systems, regulation and supervision are essential elements to guarantee appropriate liberalization. However, even with strong fundamentals in these areas, it has proved quite difficult for developing and transition economies that liberalize the capital account to adapt to the conditions generated by volatile international capital flows, which may in fact weaken or destroy those fundamentals. Boom-bust cycles are frequently associated with portfolio and short-term capital flows. Thus, the *composition* and not only the magnitude of flows play an essential role in generating external vulnerability.

Under these conditions, developing and transition economies should retain the right to impose disincentives or controls on inflows, particularly in times of capital surges, and on outflows during severe crises. A flexible approach in this regard is certainly superior to mandatory capital account convertibility. Best practices in these areas should be analyzed, to be replicated when appropriate. They could include reserve requirements on short-term inflows, various taxes on capital inflows intended to discourage them, and minimum stay or liquidity requirements for investment banks and mutual funds that wish to invest in the country. They could also include complementary prudential regulations on domestic financial institutions, such as higher reserve or liquidity requirements on short-term deposits into the financial system that are managed in anticyclical fashion, and

upper limits on the prices of assets used as collateral during periods of economic expansion. Mechanisms to guarantee an adequate maturity structure for external (and even domestic) public-sector indebtedness are also crucial complementary tools. Such instruments should be regarded as *permanent*, rather than temporary devices, as long as international financial markets remain volatile and domestic economic structures are weak. Parallel reforms should be oriented towards developing long-term segments of the domestic capital markets.

Considerations regarding the autonomy of developing and transition economies to manage the capital account should therefore be incorporated in the current discussions on broadening IMF mandates to include capital account convertibility, and in possible future discussions on multilateral investment agreements, including the agreement being negotiated in the framework of OECD. It must be clear that any ambitious liberalization of the capital account of developing and transition economies would require equally ambitious reforms in other areas of the international financial architecture, particularly a true and effective "lender of last resort", an issue which, as we have seen, is not a priority in the current agenda.

DEBT STANDSTILLS AND SHARED BURDENS OF ADJUSTMENT

A standstill on debt servicing is an efficient alternative to disorderly capital flight, once a country faces severe international illiquidity. Capital flight is bad not only for debtor countries, but also for most creditors. Through chaotic exchange rate depreciation and interest rate increases, capital flight worsens the plight of domestic companies and banks, increasing the chance that what is actually a problem of illiquidity may turn into one of insolvency. Domestically, the economic and social costs of adjustment increase. Externally, the probability that creditors as a group may be repaid decreases. Moreover, bailout operations generate significant problems of moral hazard and an inequitable sharing of adjustment. Government guarantees, which are generally sought for the external liabilities of private debtors by international lenders in the renegotiations involved in these operations, increase moral hazard and equity problems. Indeed, they imply that poor sectors of society that did not share in the capital inflows will bear a significant share in adjustment costs, through cuts in social spending.

One way out of these difficulties would be to allow the introduction of standstills on external obligations and capital account convertibility and then to bring the borrowers and lenders together to reschedule debt, while providing financial assistance to support smoother functioning of the economy. Through these "bailing-in" operations, agents in the distressed country have a better chance of surmounting their problems. If financial crises are twin crises — i.e., simultaneous international illiquidity and bank insol-

vency — creditors are also likely to recover a larger proportion of the value of their assets through this approach. The costs of adjustment are also more equitably distributed. Article VIII of the Articles of Agreement of the Fund could provide a statutory basis for the application of debt standstills.[4] To avoid moral hazard on the part of borrowers, it may be advisable that standstills be sanctioned by the Fund. They could then be combined with IMF lending into arrears to make up the liquidity needed by the economy to function during the renegotiation of its debt. An alternative would be for the standstill to be declared unilaterally by the debtor country, but then submitted for approval within a specified period to an independent panel, whose sanction would give it legitimacy. This would be the equivalent in the realm of international finance to safeguard provisions in the realm of trade.

To ensure that this mechanism operates properly, two rules are essential. First, there should be internationally agreed "collective action clauses" in international lending.[5] We therefore welcome the support given by the Group of Seven to the introduction of such clauses, which are essential for more orderly debt workouts. Their generalized introduction is crucial to avoid "free riding".[6] Second, renegotiations should take place within a specified time limit, beyond which either the Fund or the independent panel would have the authority to determine the conditions of the debt rescheduling. Repeated debt renegotiations have, in fact, been one of the most troublesome features of the international financial landscape in recent decades and an underlying cause of the prolonged periods of crisis or slow growth in some developing and transition economies.

AN INCREASED ROLE FOR REGIONAL AND SUBREGIONAL ORGANIZATIONS

Most proposals for the reform of the international financial architecture involve strengthening a few international institutions. It can be argued that stronger regional and subregional institutions can play a significant role, in terms of both the stability of the world financial system and the balance of power relations at the international level. The experience of Western Europe, from the Payments Union in the early post-war years, to the European Union and the Euro today, suggests that regional financial organizations and arrangements can play an essential stabilizing role. More limited experiences at a regional level, including regional and subregional development banks and a few reserve funds, indicate that they can also play an important role in a new international financial architecture, both in crisis management and in finance for development. Strong regional reserve funds would at least partially deter would-be speculators from attacking the currencies of individual countries and thus, among other dire effects, from threatening regional trade and financial relations. They could also supplement IMF funds in times of difficulty. Thus, on both the

demand and the supply sides, they could reduce the need for IMF support.

Most regional financial institutions are small, where they do exist, and thus have limited effectiveness, but an investment in their development would certainly pay off in the long run. The design of the new architecture could thus introduce special incentives to develop such institutions. For instance, common reserve funds could be given special automatic access to IMF financing and/or a share in the allocation of SDRs, proportional to the paid-in resources. Indeed, in the long run, IMF could be visualized as part of a network of regional reserve funds, and its operation could then concentrate on relations with these reserve funds rather than on support to specific countries in difficulties.

Moreover, regional institutions and peer review could also play a central role in surveillance, both of macroeconomic policies and of domestic financial regulation and supervision. Indeed, such surveillance and peer review could be more acceptable to countries than that of a single, powerful international institution. It would contribute towards a more balanced globalization.

COMPLEMENTARY ACTION IN DEVELOPMENT FINANCE AND EXTERNAL DEBT

During the current crisis, the focus has been on countries with large financing needs that strain the resources of multilateral institutions. It is important that the attention given to these widely publicized cases and the large volume of IMF and bilateral funds that have been committed to them do not crowd out funding for, and international attention to, the problems of the poorest countries and hence to the financing of the Fund's Enhanced Structural Adjustment Facility (ESAF), the International Development Association (IDA) and the heavily indebted poor countries (HIPC) initiative. Nor should they be allowed to crowd out funding and attention to smaller countries that may be facing financial crises.

The inability of the Fund to mobilize all the resources needed for the rescue of countries in financial distress has required it to arrange financing from other sources, including the World Bank and the regional development banks. These institutions were not designed to provide liquidity to countries facing short-term external financing difficulties. A continuation of this practice would impair their capacity to fulfil their fundamental mission, which is to cater to the long-term development financing needs of countries with inadequate access to private markets.

Special attention should be given to safeguarding the access of the poorest countries to long-term resources, at the Fund, the World Bank and the regional development banks. Accelerated implementation of the HIPC initiative is also a world priority, but bolder debt relief initiatives should also be considered. The development banks could contribute to the alleviation of the worst effects of the

crisis by providing financial assistance for the establishment or strengthening of social gender-equitable safety nets in both poor and middle-income countries. Strong protection for the poor during crises, through the design of effective safety nets, is still more a matter of rhetoric than of practice. Development banks also have a clear countercyclical role to play in world financial crises, a role that could be enhanced through innovations enabling them to work more actively to "crowd in" private-sector financing by rapidly disbursing co-financing funds or guaranteeing new debt issues of developing and transition economies. New, more effective rules on guarantees issued by these institutions must be designed to ensure this result.

INTERDEPENDENT COMPONENTS OF A NEW ARCHITECTURE

The goal of redesigning the international monetary and financial system is to harness the potential of private international financial flows to the service of stability and growth in the world economy. In order to pursue this objective effectively, it is important that the various components of the architecture be addressed at the same time. Indeed, these components are interrelated, and putting one or some of them in place in isolation will have limited impact in reducing the disruption caused.

Thus, improvements in supervision and regulation of financial firms are preventive measures that can reduce the incidence of crises and hence the need for IMF resources to cure them. However, since supervision and regulation are far from foolproof, financial crises and contagion will remain problems that need to be dealt with at the international level. Macroeconomic coordination and surveillance are essential to manage both inflationary and deflationary situations, which lie behind boom-bust financial cycles. Regional and subregional institutions could play an essential role as complements to IMF funding and surveillance activities, as well as in surveillance of domestic financial regulation and supervision.

Likewise, new financing facilities and standstill provisions are not substitutes for better regulation and supervision of financial institutions. Rather, all the above measures, along with domestic measures to deal with short-term capital movements, are mutually complementary. Rules regarding internationally sanctioned standstills are also no substitute for the establishment of an IMF facility to deal with contagion. Standstills have the unintended consequence of shutting off borrowers from access to capital markets for some time. Just as countries have legitimate differences in their preferences for integration into international financial markets, they would also differ in their willingness to call a standstill. The least willing are likely to be those whose liquidity crises are to a great extent the result of contagion and which have a high degree of integration into international financial

markets. Therefore, a well-functioning international financial system will require both standstills and institutional innovation at the IMF.

Standstills cannot be implemented without regulations on capital outflows. In effect, capital controls will become indispensable when a country cannot meet its external payments because of a run on its currency. Hence, the recognition of the need for diversity with regard to approaches to the capital account cannot be divorced from the establishment of norms to deal with crisis situations.

Reliance on any one or even a few of these proposals would hardly bring about the changes needed to both prevent and manage crises or lead to greater equity in power relations. There is an evident need for a comprehensive and well-timed approach, in order to generate a more balanced and hence enduring globalization process and to ensure that it contributes effectively to sustainable human development. ■

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Explanatory Note

This report was issued in January 1999, by the United Nations Executive Committee on Economic and Social Affairs. It was brought to fruition by a Task Force created by the Committee and led by Mr. Jose Antonio Ocampo, Executive Secretary of the Economic Commission for Latin America and the Caribbean. The Executive Committee on Economic and Social Affairs consists of the following 16 members: Department of Economic and Social Affairs (DESA), Economic Commission for Europe (ECE), Economic and Social Commission for Asia and the Pacific (ESCAP), Economic Commission for Latin America and the Caribbean (ECLAC), Economic Commission for Africa (ECA), Economic and Social Commission for Western Asia (ESCWA), United Nations Conference on Trade and Development (UNCTAD), United Nations Environment Programme (UNEP), United Nations Centre for Human Settlements (HABITAT), United Nations Office for Drug Control and Crime Prevention (ODCCP), United Nations High Commissioner for Human Rights (OHCHR), United Nations Development Programme (UNDP), United Nations University (UNU), International Research and Training Institute for the Advancement of Women (INSTRAW), United Nations Institute for Training and Research (UNITAR), and United Nations Research Institute for Social Development (UNRISD).

NOTES

[2] Under Article IV of the IMF Articles of Agreement, the Fund makes an annual assessment of the macroeconomic situation and policy in a member country and engages in consultations with the authorities, in particular, regarding the sustainability of its balance of payments.

[3] "Sovereign risk" refers to the possibility that a government will be unable to service its debt, usually in the context of having insufficient foreign exchange to pay foreign creditors or bondholders.

[4] When accepting the principles of Article VIII of the Fund's Articles of Agreement, members agree, among other conditions, not to place restrictions on payments and transfers for current international transactions without IMF approval, and to maintain orderly exchange arrangements and a uniform rate of exchange for their currencies. There is a clause in the article, however, that could be interpreted to permit approved suspension of debt servicing.

[5] In order to restructure interest and/or principal obligations on a syndicated bank loan, the creditor banks in the syndicate have to agree. In such cases, the new terms are typically negotiated by a committee of the bankers and apply to all once they are accepted by the requisite majority of banks, as per the terms of the syndicated loan. Such procedures are much more difficult to arrange for bond issues, especially as the number of bondholders are much larger than the number of banks in a syndicate and more dispersed; also, individual bondholders could more easily upset a potential agreement through court action than in the case of bank debt. "Collective action" clauses in bond agreements would set out the conditions, procedures and majorities needed for debt renegotiation so as to facilitate restructuring of obligations as needed.

[6] A "free rider" gets the benefit of something without "paying" for it. In the context of the text, if most of a country's debt servicing obligations were restructured, at some inconvenience if not loss to the creditors, it might free up enough foreign exchange to fully service the debt of a creditor that did not participate in the agreement. Each individual creditor thus has an incentive to remain outside the debt renegotiation ("collective action" clauses are meant to overcome this by imposing the settlement on all creditors in a particular class, once a qualifying majority adopts it, regardless of whether the individual creditors agree to the terms or not).

The International Monetary Fund: A Cure or a Curse?*

BY DEVESH KAPUR

IMF economic policy enthusiasms, diagnoses and prescriptions have been badly misdirected for many years. A recent case is its promotion of unfettered global capital flows, which had a damaging impact on several Asian economies in 1998. This is only the latest in "a long series of ad hoc solutions on an increasingly dilapidated system of global governance," according to Devesh Kapur. An assistant professor at Harvard University, Mr. Kapur is co-author of The World Bank: Its First Half Century *(Brookings, 1997) with John Lewis and Richard Webb.*

IN NOVEMBER 1996, an International Monetary Fund (IMF) publication reporting on an IMF-sponsored conference in Jakarta trumpeted, "ASEAN's Sound Fundamentals Bode Well for Sustained Growth." The central message of the conference, it stressed, was that "the region is poised to extend its success into the twenty-first century and that governments still have a major role in driving this process.... Participants' confidence...was rooted in the region's strong macroeconomic fundamentals; in ASEAN's (Association of Southeast Asian Nations) tradition of, and commitment to, efficient allocation of investment; and in the widespread belief that the external environment will continue to be supportive." If the IMF was publicly confident about the strength of Asia's "fundamentals," it was even more enamoured with the virtues of the international capital movements that were helping fuel the region's remarkable growth.

Even as Asia's ongoing economic crisis began to unfold in the summer of 1997, the IMF was strongly pressing its members to amend its charter (for just the fourth time in its 53-year history) to make the liberalization of capital accounts a specific goal of the Fund, and to give it "appropriate jurisdiction" over capital movements. It took less than a year for the IMF to decry Asia's "fundamentals" as severely wanting. The crisis, it argued, was "mostly homegrown." Instead of urging the prompt dissolution of capital controls, IMF Managing Director Michel Camdessus began calling for "orderly, properly sequenced and cau-

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tious" liberalization of government controls on money flows in and out of countries. The mistakes of the past, however, did not deter the IMF from intervening in Asia's crisis countries with unprecedented zeal. But if the IMF's predictions about Asia were so wrong, why should its prescriptions be any better? Do they flow from a technocratic diagnosis? Or do they merely mask the institution's own interests and those of its controlling owners? For that matter, just exactly whose interests does the IMF represent? Its actions during the Asian financial crisis not only cast the answers to these questions in sharp and disturbing relief, but also raise serious doubts about the soundness of the institutional architecture for global governance in general, and for international economic and financial management in particular.

LETTING THE RECORD SPEAK

If the IMF had a dollar for every criticism of its purpose and role by the Right, the Left, and the Center, it would perhaps never again have to approach its shareholders for more money to sustain its operations. Countless Wall Street Journal editorials have denounced the institution's "bailouts" and tax-raising proposals as efforts to prop up "bloated" States. Left wingers claim that the fund's policies are a not-so-thinly-disguised wedge for capitalist interests — a view underscored by former U.S. trade representative Mickey Kantor's colourful rendering of the institution as a "battering ram" for U.S. interests. A more banal interpretation portrays the IMF as a hapless Wizard of Oz figure, "a mythologized contraption through which weak human beings speak," to use one observer's words, whose effects are far more limited than its champions and its critics would have us believe.

The IMF's actual record is helpful in sorting out these many overblown and conflicting claims. Founded in 1944 (see box), the institution played a modest but important role in maintaining stable exchange rates in its first two decades. This raison d'être collapsed after 1971, when the major currencies moved to a floating exchange rate system. Since then (and especially after 1978, when the second amendment to the IMF's charter formally ratified the move to floating exchange rates), its engagement with industrialized countries has been largely pro forma. By the beginning of the 1980s, with commercial bank lending in high gear, the IMF's clientele had shrunk to those poor countries to which no commercial bank was willing to lend. Until the mid-1980s, Fund programmes in these poor countries were relatively narrow and generally of short duration.

The mistakes of the past did not deter the IMF from intervening in Asia's crisis countries with unprecedented zeal.

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Loan conditions focused on currency devaluations, budget cuts, higher taxes, and curbs on the supply of credit in the economy.

Naturally, however, there was no shortage of criticism. Nationalists of all hues lamented the loss of sovereignty entailed by the requirements of IMF programs. More tellingly, critics questioned the Fund's single-minded attention to budget deficits, particularly its tendency to ignore the political realities that led governments to cut politically expedient expenditures (funds for primary education, for example), while protecting more politically powerful interests (those of the military and university students). By the same token, governments desperate to meet IMF-mandated targets often chose to impose tax increases that followed the path of least political resistance — raising sales taxes instead of property taxes, for example. In short, criticisms of Fund programmes frequently served to mask the actions of the same politicians and policy-makers who were largely responsible for their countries' predicaments. Despite the IMF's best intentions, the realities of local politics often resulted in outcomes that were socially regressive, economically myopic, and only modestly able to put a country back on a sustainable growth path. A burst of IMF programs in Africa at the end of the 1970s, for example, proved singularly ill-advised for a continent whose economic problems stemmed from deep-rooted political and social causes. Then again, Fund programmes significantly helped countries that had viable institutional infrastructures and were willing to implement tough decisions (such as India, Indonesia, South Korea, and Thailand in the 1970s and 1980s).

THE DEBT CRISIS: A HISTORICAL PIVOT

The advent of the Latin American debt crisis in 1982 marked a major turning point for the IMF's fortunes. Navigating skillfully through uncharted waters, the Fund helped to forestall the dangers posed by the crisis to the global financial system. But its role in the debt crisis also had two important long-term consequences for the institution. First, it became the equivalent of a debt collector for commercial banks. Second, the IMF expanded its mandate to promote structural reforms.

1) The "Creditor Community's Enforcer":

Although both debtors and creditors shared blame for the 1980s debt crisis, the costs of adjustment were borne asymmetrically by debtor countries, which suffered their worst economic decline since the Great Depression. Even as the Fund's programmes grew in number, its net lending shrank. Particularly embarrassing for the IMF was the contrast between the late-1980s increase in repayments by Latin nations and the further contraction of their economies. Describing the IMF as the "creditor community's enforcer," former Columbia

HOW THE IMF WORKS

The International Monetary Fund (IMF) and the World Bank — known as the Bretton Woods institutions — were established in 1944. The purpose of the IMF was to promote international monetary cooperation, exchange rate stability, and the expansion of international trade by acting as a lender of last resort when a member country faced an economic crisis. In principle, the IMF has a structure akin to a financial cooperative. A member country's contributions to the IMF (called "quotas") are based on its weight in the global economy. This weight also determines its voting power and borrowing capacity (called "drawings").

Quotas amount to an exchange of assets with little direct cost to taxpayers. For instance, in the case of the United States, its contributions entitle it to an equal amount of U.S. claims on other currencies. That is, just as other countries can draw U.S. dollars from the IMF in times of need (such as pressures on the U.S. dollar), the United States can draw their currencies (be it the Japanese yen or the German mark) for itself. In fact, the United States has drawn on the IMF on 28 different occasions, most recently a $3 billion drawing in 1978.

By approaching the IMF, a member country facing a financial crisis has access to the Fund's resources and advice. As a country's drawings become larger relative to its quotas, it must meet more exacting standards or "conditionalities," which typically mean significant changes in economic policies to ensure that the country's domestic and external deficits are drastically lowered or even eliminated. Failure to meet those conditions results in suspension, renegotiation, or even cancellation of the programme. Although the total size of the IMF's quotas increased from about $9 billion at its creation to nearly $200 billion in 1997, it has declined relative to almost all relevant global economic indicators, whether the size of world trade, international reserves, or international financial flows.-D.K.

University professor Karin Lissakers (now the U.S. executive director at the IMF) noted that the behaviour of "a political organization" such as the IMF "raises the question of which way will its biases go" when placed between debtors and creditors. Denunciations by MIT professor Stanley Fischer (currently the IMF's first deputy managing director) of the institution's "mistaken no-debt-relief strategy" were seconded by Jacques Polak, a respected former research direc-

tor and later the Dutch executive director, who complained that the institution was "being used by the commercial banks in the collection of their debts." This debt-collector role inevitably undermined the institution's credibility. Its economic projections, for example, became malleable to major shareholder pressure (see box). As former Federal Reserve chairman Paul Volcker once bluntly said of the IMF's numbers in the debt crisis, they were "negotiated" numbers, embracing in some instances what former IMF research director Jacob Frenkel called "considerations other than purely analytical ones."

Indeed, if "the record shows that frank and open debate does not take place in official and banking circles" (to use Fischer's 1989 characterization of the Bretton Woods institutions' behaviour in the debt crisis), a decline in client trust is inevitable.

2) The Advent of Structural Reforms:

A second consequence of the debt crisis was that the IMF, chastened by the modest results of its programmes and pressed by its critics, reformulated its approach. Rather than focus just on the size of budget deficits and the magnitude of revenue increases and the expenditure cuts needed to correct them, the Fund began to demand specific cuts and increases — for example, pressing some countries to protect social programmes and prune military spending. As the economic travails of Africa and the IMF's very limited success there — became evident, Fund programmes became even more detailed. To counter criticisms that its policies hurt the poor, or its bias toward austerity and exports encouraged environmental destruction, the Fund added poverty alleviation and governance-related issues (such as corruption) to its agenda — a trend reinforced by the East European countries joining the Fund at the end of the 1980s. In many cases, the IMF devised loan conditions at the behest of borrowers, whether local officials who felt powerless to sway their political leaders or politicians who used the IMF to shield themselves from popular rejection of policies that they too recognized as essential. Although there was more rhetoric than reality to these changes in the Fund's approach, its loan conditions were clearly moving beyond merely requiring fiscal and monetary adjustments. An equally clear and more troubling trend implicit in the IMF's mission creep was its growing hubris. Spurred on by the demands of its principal owners and the internal activism of its technocrat managers, the Fund began to assume that all that was deemed good for a country should also be part of its mandate. As a result, its overlap with its Bretton Woods sister, the World Bank, grew. And with the major powers holding a "very pro-Fund view" relative to the World Bank (again, to use Fischer's words), the advice emanating from the

A FRIEND IN NEED

Examples abound of political pressures undermining the IMF's institutional effectiveness. Despite clear evidence of gross misalignment of Francophone Africa's currency, it was open knowledge that France pressured the Fund to keep it from pushing for devaluation. The pivotal role of Egypt in the Middle East led the IMF, under pressure from the United States, to interpret its loan conditions more flexibly. A long history of failed programmes to the Mobutu regime in Zaire was a particularly egregious instance of institutional flexibility to accommodate major power interests (in this case, Belgium, France, Germany, and the United States). Likewise, there are strong political reasons why the IMF was willing to finesse corruption-related loan conditions for Russia in a way that it was not willing to do for Kenya.-D.K.

Bretton Woods institutions began to have an increasing IMF flavour.

MEXICO 1994: A MODEL CRASHES

The aftermath of the 1980s debt crisis led to a consensus among policy-makers that less developed countries (ldcs) should place greater reliance on market forces. When coupled with sound macroeconomic policies (especially low budget deficits), liberalized financial markets would produce stronger growth and enable the self-correcting mechanisms of market discipline to work. Countries such as Mexico, which sharply reduced their budget deficits, privatized State-owned enterprises, and welcomed foreign investment, were praised and rewarded by the Fund and Wall Street as star pupils who could do no wrong. Evidence to the contrary was ignored or pooh-poohed by an IMF determined to uphold and spread its model of economic reform.

So, when financial crisis hit Mexico in December 1994, the IMF (not to mention Wall Street, the media, and most academic analysts) was, to put it mildly, caught offguard. The massive $40 billion financial package that the IMF organized for Mexico in 1995 — at the time its largest package ever — was only possible because Mexico borders the IMF's largest shareholder. The package prevented a default and allowed Mexico to regain access to financial markets, while limiting the impact of the crisis on other countries in the region. But it also set a precedent. At the very least, it held out the likelihood that foreign creditors could expect to be bailed out in similar situations. And although several recent commentaries have hailed the IMF's intervention as a "success," such a characterization glosses over the somber reality that real wages in Mexico are still one-quarter below their pre-crisis levels

of more than three years ago. The IMF's postmortem of the Mexican crisis concluded not that the Fund was wrong, but that it lacked the wherewithal to be right. It identified a generic problem afflicting ldcs — a lack of transparency — and asked its shareholders for additional policing powers and resources to correct it.

Persuading nations to make more financial information available to international institutions such as the IMF (and to the public) would doubtless help avert or defuse crises. But there are limits to this approach. Even if the IMF had more relevant information, it would have to remain discreet in the face of an emerging problem, since financial markets have a tendency to make even not-so-diré predictions by such institutions self-fulfilling. And the more information that the IMF asks for, the less countries are likely to be able to provide it, at least within the rapid time frame that markets move, and especially when global money managers sense looming problems. Finally, it is not the availability of information that matters per se, but its interpretation. There are none so blind as those who will not see; and staring at the proverbial pot of gold can be blinding. A more curious response to the peso crisis was the Fund's enthusiasm for unfettered global financial markets. That global financial markets bring high risks and high rewards is well established. But since the poor have less capacity to bear risk, the IMF might have been expected to move cautiously in integrating poor countries into global financial markets, despite the high potential rewards. As Larry Summers put it when he was chief economist at the World Bank, in banking as in nuclear plants, "free entry is not sensible." But arguing that the benefits of free capital movements were substantial, the Fund began its campaign to bring the promotion of capital account liberalization under its mandate and jurisdiction barely a year and a half after the Mexico crisis. Of course, another factor behind the Fund's views may have been the sentiment subsequently expressed by Summers in his current capacity as deputy secretary of the U.S. Treasury: namely, that "financial liberalization, both domestically and internationally, is a critical part of the U.S. agenda."

ASIA 1998: DEJA VU WITH A DIFFERENCE

The consequences of the IMF's experience in earlier crises are manifest in its unfolding role in the Asian crisis. As before, the Fund's diagnosis has emphasized the internal roots of the problem: the failure to control large balance-of-payments deficits; the explosion in property and financial markets; mismanaged exchange rate regimes; rapidly expanding financial systems that were poorly regulated; and an unwillingness to act decisively once confidence was lost. But, as in the past, the Fund's focus on in-country factors has deflected attention from both its earlier firm endorsement of these countries' policies and its unbri-

dled cheerleading on removing the barriers impeding globalization.

Indonesia, Korea, Malaysia, and Thailand had thrived for years, despite weak financial systems and numerous destabilizing external events, including the oil shocks of the 1970s and the soaring dollar of the early 1980s. And, yes, crony capitalism had thrived as well — if anything, in a rather transparent way. Now the IMF and international capital markets claimed they were shocked, just shocked, to find that the regime's impressive economic achievements were built on such dodgy foundations.The countries did make egregious mistakes — perhaps the worst was their overconfidence that their success was somehow uniquely based on quasi-magical "Asian values." In reality, their economies were undone not by visible internal flaws, but by the unforeseen impact of the global capital flows that the IMF sought to set free. The conventional macroeconomic indicators of the Asian crisis countries were well within prudential norms. These were not profligate governments whose policies yielded large deficits and inflation. Current account deficits in Thailand were extremely high, but that was hardly a secret. In hindsight, there were cracks in exchange rate regimes, especially in Korea and Thailand; yet they were not apparent at the time, and exchange rates were not excessively overvalued. But the combination of huge capital inflows with high domestic savings rates tempted inexperienced business executives and corrupt and incompetent politicians, particularly when the State implicitly stood behind the financial speculations of private institutions. When a domestic asset bubble bursts, the consequences can be painful. Capital flight severely amplifies the pain. In the case of the Asian crisis, a vicious circle set in. As capital flooded out, exchange rates collapsed, and a wave of bankruptcies by firms unable to pay their foreign debts engulfed the private sector, leaving the countries at the mercy of panic-stricken private lenders and obdurate official ones.

The IMF assembled a mammoth financial package — US$17 billion for Thailand, US$43 billion for Indonesia, and US$57 billion for Korea — with resources drawn from the IMF itself, together with the World Bank, the Asian Development Bank, and leading governments. Despite the poor judgment shown by financial markets (differences in interest rates between Asian and U.S. sovereign debt, a measure of the relative risks that markets attached to these countries, had continued to narrow until the first half of 1997, shortly before the crisis), resources disbursed by Fund programmes have been used by the crumbling Asian economies to pay off foreign creditors. But the disbursements were linked to the countries meeting a range of conditions that seem to go well beyond the IMF's mandate. Two decades ago, Fund programmes typically imposed a dozen or so requirements or strictures.

But the Asian countries have had to sign agreements that look more like Christmas trees than contracts, with anywhere from 50 to 80 detailed conditions covering everything from the deregulation of garlic monopolies to taxes on cattle feed and new environmental laws.

Many of the objectives underlying these conditions are laudable. Unfortunately, they also reflect a troubling lack of institutional self-restraint. According to Fund sources, conditions such as the one asking Korea to speed up the opening of its automobile and financial sectors reflected pressures from major shareholders (Japan and the United States). In Indonesia, detailed conditions related to the banking sector were imposed despite the Fund's limited expertise in this area. In November 1997, the Indonesian Government shut 16 banks at the IMF's insistence without providing firm assurances that the Government would stand behind those banks that remained. The resulting bank run almost dragged down the entire Indonesian banking sector. By the IMF's own admission, a fragile system was pushed over the brink — a tragic illustration of the folly of institutional overreach.

RESTORING THE BALANCE

Against the backdrop of the IMF's history of the last 50 years, the Asian financial crisis suggests four conclusions:

The first and most evident conclusion is that, as Federal Reserve chairman Alan Greenspan remarked recently, the global financial system seems to facilitate "the transmission of financial disturbances far more effectively than ever before." Many analysts now share the view that foreign financial flows should be regulated in some way. The question is how to make openness to the world's capital markets less perilous.

Although ldcs undoubtedly need to open up to the world's capital markets, they would be well advised to do so at a pace commensurate with their capacity to develop sound regulatory and institutional structures. In particular, tighter limits on short-term foreign borrowing — especially by banks — may well be essential.

This need for greater prudence on the part of ldcs is underscored by the failure of various proposals designed to protect nations from the full force of global financial flows (such as a tax on international financial transactions or financier George Soros's suggestion for a publicly funded international insurance organization). In theory, when a financial crisis does occur, there should be an international equivalent of domestic bankruptcy codes that would create a legal venue

The global financial system seems to facilitate the transmission of financial disturbances far more effectively than ever before.

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for creditors and debtors to resolve their differences, and allow both sides to avert financial panics and to stop shirking their responsibilities. But the major actors in international financial markets dislike the idea. Perhaps this is because they are aware that more pressure can be brought onto ldcs through the IMF than through a judicial "due process." Barring much greater losses in major industrialized countries, support for any of these proposals is unlikely.

A second conclusion is that "moral hazard" — the propensity in both borrowing countries and creditors to take excessive risks because of the implicit insurance offered by bailouts — applies to the IMF as well as to borrowers and creditors. In the case of borrowers, costs to their citizens and polities vastly exceed financial inflows from the bailouts. Thus, to say that borrowing countries will misbehave in hopes of being "bailed out" is to miss the point. The hazard (moral or otherwise) is that ldc leaders will use the IMF and other external forces to steer domestic discontent away from their own machinations. There is perhaps greater "moral hazard" among creditors, particularly in the banking segment of the financial sector — a subject much commented on in recent years.

More worrisome is a certain moral hazard on the part of the IMF and its major shareholders. The steady expansion of institutional objectives (and loan conditions) has occurred because borrowing countries bear a disproportionate share of the political, economic, and financial risks of IMF programmes. There is little downside to these programmes for the Fund's major shareholders, its management, or staff. Financially, IMF-led bailouts impose few net costs on the industrialized countries, since the Fund has always been repaid (with the exception of Sudan, arrears to the IMF exist only in the case of countries that have imploded). The damage resulting from the IMF's mishandling of the Indonesian banking sector was entirely borne by the country — not by the IMF or the board that had signed onto these conditions. The IMF's apex role among multilateral financial institutions means that it is the first to go into crisis countries — but also the first to get out — further reducing its financial risks.

Borrowing countries bear a disproportionate share of the political, economic, and financial risks of IMF programmes.

Instead of underscoring the Fund's limitations, the various crises that have afflicted ldcs have enlarged its resources and mandate, an aggrandizement driven by the bogeyman of "systemic" threats to the world's financial system. If the financial risks are few for the IMF, the political risks are even fewer. The Fund is largely irrelevant to managing economic relations among major economic pow-

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IGNORANCE VERSUS HYPERBOLE

The United States is the IMF's greatest financial supporter, with a quota — or "membership fee" — that accounts for roughly 18 per cent of total IMF funds. But lately, U.S. leadership has seemed to be at best a mixed blessing. The acute hostility of the U.S. Congress toward the IMF (indeed, toward almost all multilateral institutions) is matched only by its abysmal ignorance of how the IMF actually works. Congressional attitudes are driven by an *idée fixe* that these institutions impose significant costs on U.S. taxpayers. Yet, as Secretary of the Treasury Robert Rubin recently pointed out, U.S. participation in the IMF "has not cost the taxpayer one dime." In fact, IMF managing director Michel Camdessus argues that over the last 15 years, the United States has actually made a small profit (of a little under US$100 million annually) from membership in the institution.

Republican Senate leader Trent Lott's characterization of Camdessus as "a socialist from France" (who should hence be fired) and his insistence that U.S. contributions to the IMF waste "taxpayers' money", could be dismissed as uninformed demagoguery, if such comments did not have major repercussions for IMF funding and policy. But not only does Congress have the power of the purse over U.S. quota increases, it can — and increasingly does — use that power to attach conditions (such as a ban on funding organizations that support the right to an abortion overseas) to U.S. legislation that would finance the IMF. Recent debate over the "abortion provision" in the House of Representatives, for example, has stalled U.S. approval of US$18 billion in new financing for the IMF.

Meanwhile, in order to sell quota increases to Congress, the U.S. Treasury (and the allies it marshals to buttress its case) exaggerates what the Fund can do, not just for developing nations, but for the "national interest." As one such booster recently testified before the Senate, the IMF "is in fact one of the best possible deals we could ever imagine: Its programmes cost us nothing yet it provides enormous benefits for our economy and our foreign policy." This kind of rhetoric hardly helps policy-makers in crisis-ridden countries who must defend Fund programmes to suspicious nationalists who deplore U.S. hegemony. And later, when these unrealistic expectations are not met, the IMF's credibility suffers.-D.K.

ers. As a result, its member countries are divided into "structural" creditors and debtors, with the latter group comprising ldcs and, more recently, countries making the transition from central planning to market economies. With this division, the essence of the institution as a cooperative has dwindled. Knowing that they were unlikely to borrow from the IMF, the major economic powers have had fewer qualms about continually expanding its power and role. For example, many European members of the IMF signed on to conditions calling for greater labour market flexibility in Asia without pausing to reflect on the situation in their own countries, where extremely rigid labour markets have resulted in soaring unemployment. This contradiction has less to do with an apparent double standard than with the unlikelihood of many European nations ever being subject to IMF strictures.

A third conclusion is that the continued expansion of the IMF's power and mandate is bad for debtor nations, for the global financial system, and, ultimately, for the IMF itself. The increasing scope of loan conditions implies that during a financial crisis, the IMF should take over more and more of a country's decision-making process, without any commensurate increase in accountability. Put in a different way, the absence of risk sharing means that these conditions amount to a form of political taxation without representation. Moreover, in today's financially rooted economic crises, expanding the IMF's agenda (and its associated loan conditions) can be self-defeating. Unlike the slow-burning "old style" economic crises caused by macroeconomic imbalances, financial crises can spread globally like wildfire. Quick and decisive action is necessary to bring them under control. The widening of loan conditions invariably results in a loss of precious time, whether during negotiation or implementation, making a bad situation worse. The long-term damage to the IMF itself should also not be underestimated. In the absence of rules designed to ensure self-restraint, its staff — like that of any other bureaucracy — will always push the Fund toward policy prescriptions that give them greater prominence and influence. Observers of governmental bureaucracies have long recognized that a multiplicity of missions impairs bureaucratic effectiveness and erodes institutional autonomy. The IMF's widening agenda has made it both less effective and more vulnerable to politicization, thus tarnishing the technocratic reputation that is essential to the credibility of its prescriptions. As its goals increase, the cri-

The continued expansion of the IMF's power and mandate is bad for debtor nations, for the global financial system, and, ultimately, for the IMF itself.

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teria for "success" become more elusive, leading the institution to tout its own "achievements" ever more ardently with discrediting results, as demonstrated by the debt crisis in the 1980s, and again by the 1994–95 Mexican peso crash.

The final conclusion is that by placing the onus of adjustment solely on debtor countries, the Fund's actions relieve any pressure on creditor countries to change the status quo, whether the creaky architecture of international organizations set up 50 years ago, an exchange rate regime whose gyrations trap weaker countries, or the increasingly ineffective regulation of international finance. Today, the principles for which the IMF claims to stand are increasingly at odds with the way in which it conducts its own affairs. It promotes the virtues of democracy — while deeming them impractical, if not downright dangerous, for multilateral governance. It derides and discourages State intervention in economic affairs — while insisting on its right to restructure from top to bottom the economies of the ldcs. And it rejects the need for international controls on capital as invidious — while asserting the need for those on labour to be obvious.

This welter of contradictions serves to highlight the corrosive impact of a long series of ad hoc solutions on an increasingly dilapidated system of global governance. Ultimately, the limitations of multilateral institutions such as the IMF reflect the limitations of those nation-States that created them. And, if as a normative principle power should go hand-in-hand with responsibility, then those States with the most power in these institutions must bear the blame for their failings and assume the greatest responsibility for their rejuvenation.

WANT TO KNOW MORE?

For views on the IMF's role in international monetary cooperation, see Harold James' *International Monetary Cooperation since Bretton Woods* (Washington: IMF and New York: Oxford University Press, 1996) and Margaret Garritsen de Vries' *Balance of Payments Adjustment, 1945 to 1986: The IMF Experience* (Washington: IMF, 1987). A more recent perspective on the IMF's mandate is Michel Camdessus' speech, "The Role of the IMF: Past, Present, and Future" (Washington: Annual Meeting of the Bretton Woods Committee, February 13, 1998).

Two balanced treatments of IMF programmes in developing countries are Tony Killick's *IMF Programmes in Developing Countries: Design and Impact* (London; New York: Routledge, 1995) and Graham Bird's *IMF Lending to Developing Countries: Issues and Evidence* (London; New York: Routledge, 1995).

The classic book on IMF conditionality is John Williamson, ed., *IMF Conditionality* (Washington: Institute for International Economics, 1983). An elegant treatment of the evolving nature of IMF conditionality by a former senior official is Jacques Polak's *The Changing Nature of IMF Conditionality* (Princeton: Princeton

University Press, 1991). A more recent institutional perspective can be found in Manuel Guitian's "Conditionality: Past, Present and Future" (Washington: IMF Staff Papers, December 1995). There are innumerable critiques of the IMF. A sampling from the Right can be found in Doug Bandow and Ian Vasquez, eds., *Perpetuating Poverty: The World Bank, The IMF, and the Developing World* (Washington: Cato Institute, 1994). A representative collection of critiques from the Left is Kevin Danaher, ed., *Fifty Years Is Enough: The Case Against the World Bank and the International Monetary Fund* (Boston: South End Press, 1994).

Readers interested in more on the origins of the Asia crisis should consult Steven Radelet and Jeffrey Sachs' "The Onset of the East Asian Financial Crisis" (Cambridge: Harvard Institute for International Development, March 1998). For a thoughtful Fund perspective on its role in the Asia crisis, see Stanley Fischer's "The IMF and the Asian Crisis" (Forum Funds Lecture at UCLA on March 20, 1998). On the World Bank's role, refer to Joseph Stiglitz's "The Role of International Financial Institutions in the Current Global Economy" (address to the Chicago Council on Foreign Relations, February 27, 1998). Critical viewpoints include, Allan H. Meltzer's "Asian Problems and the IMF" and Charles W. Calomiris' "The IMF's Imprudent Role as Lender of Last Resort," (*Cato Journal*, Winter 1998) and Martin Feldstein's, "Refocusing the IMF" (*Foreign Affairs*, March/April 1998).

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Borrowers, Lenders AND THE Asian Financial Crisis: The "Moral Hazard"

AZIZ ALI MOHAMMED

Domestic and international financiers made many assumptions prior to the recent Asian financial crises — exchange rates will remain stable; national authorities will defend against speculative attack; major banks will not be allowed to fail; if necessary, the International Monetary Fund will organize a bail-out as it had for Mexico in 1994.

Aziz Ali Mohammed, the Consultant to the Group of 24, IMF and the World Bank, shows how these assumptions created a false sense of comfort that was actually full of hazard.

The term "moral hazard" originates in the lexicon of the insurance industry and refers to the contingency that an insurance holder takes less care than he would otherwise to prevent an event (e.g., a fire) against which he is insured. The term has acquired a generalized application, and in the context of the Asian crisis, it would refer to behaviour on the part of economic agents that results in actions or creates incentives for actions that are found to be contrary to the national or international interest. The phrase "hidden actions" is often used synonymously in order to remove the value judgement implicit in the "moral hazard" term.

Moral hazard would have been created in the crisis-affected Asian countries primarily in respect of financial transactions undertaken by domestic debtors or borrowers and by their foreign (or offshore) creditors or investors prior to the crisis or during and after its onset. Critical ingredients in the crisis were: a breakdown, in one Asian country after another, of existing exchange rate regimes following massive reversals in private capital flows; the crash of domestic equity and real estate markets; the virtual bankrupting of many domestic banking institutions, and of large elements of the corporate sector that had borrowed abroad. Actions (or

failure to act) on the part of the national authorities or by the international financial institutions (IFI) or by other official agencies would have produced moral hazard by making either debtors or foreign creditors or both behave in a manner that was contrary to the maintenance of economic stability and that might have contributed to the outbreak of crisis or intensified its effects. The following paragraphs illustrate some aspects of the hazard phenomenon without attributing any direct causal relationship with the crises nor implying that the authorities were acting deliberately, and with malice aforethought, to create the conditions under which the hazards would come into play.

A common factor in the financial crisis in several countries was the failure of most debtors to hedge the foreign exchange risk of borrowing in foreign currencies. Much of this borrowing was denominated in U.S. dollars, and it appeared rational on the part of domestic borrowers not to undertake the additional cost of hedging the risk of a change in the exchange rate against the dollar because the domestic currency had remained pegged to the dollar for long periods of time. The peg had been maintained even in the face of large fluctuations in the dollar-Japanese yen rate in the preceding years, and this despite the fact that a significant portion of the exports of the East Asian countries were disadvantaged by these fluctuations. Most borrowers would also have reasoned that the authorities held ample foreign exchange reserves to defend the peg against speculative attack. What they would not have known, for instance in the case of Thailand, the epicenter of the crisis, was that the Bank of Thailand had been intervening in the forward exchange market for the several months preceding, and that its forward sales had effectively depleted the foreign exchange reserves in a manner that was not shown in the published spot figures of its foreign exchange position. A flexible exchange rate regime and a candid disclosure of the true state of their foreign exchange reserves by the Thai authorities would have produced a better evaluation of foreign exchange risk in dollar borrowing, but in its absence, economic agents had reason to assume that there was an implicit guarantee of an invariant price for the dollar — a clear illustration of moral hazard.

Once the contagion of the Thai crisis began to spread, the same phenomenon was replicated in neighbouring countries. In Indonesia, for instance, domestic commercial banks had built up a substantial exposure in foreign currency options over the years, again on the assumption that the exchange rate would remain stable. The major banks also laboured under the illusion that they were "too big to fail" and many of the largest private corporate borrowers would have assumed that they were "too influential" to be allowed to fail. Indeed, the latter consideration created a preference for borrowing directly from foreign

sources instead of going through the domestic banking system. The illusion of invincibility on the grounds of size or political affiliation would have been fortified by the action of the Bank of Indonesia in providing liquidity freely to domestic banks, and other financial entities owned by influential parties, who were facing liquidity problems. Once the exchange rate came under pressure in the wake of the Thai contagion, the efforts of the same banks and corporate borrowers to hedge their foreign exchange exposure by making spot purchases of foreign currency only served to accelerate the depreciation of the Indonesian rupiah.

The Korean case illustrated an interrelated aspect of the assumption about implicit exchange rate guarantees. Basing themselves on the long-standing pegs of the Thai baht and Malaysian ringitt to the U.S. dollar, a number of Korean institutions had purchased, through their offshore subsidiaries, structured notes that, in effect, borrowed in yen to finance bets on the exchange rates between the dollar and the two regional currencies. When their pegs collapsed, the investors were burdened by substantial liabilities that added to the difficulties already facing the Korean financial institutions following the depreciation of their own currency vis-à-vis the yen.

Other aspects of moral hazard were also present in the Korean situation. In their gradual progress towards the liberalization of their capital account, the authorities had created a bias in favour of capital inflows through the banking system, and these tended to be short-term in character. This particular feature of interbank credit lines proved to be a major factor in generating financial crisis in a number of Asian countries since foreign banks were able to rapidly reduce their exposures by the simple expedient of not rolling over these lines when their maturities fell due. In some instances, borrowers had agreed to "put options" in their loan or bond agreements so that, for example, a bond recorded on the debtor's books as a 3-year bullet, with a "put" after one year, would be seen by creditors as a 1-year bond, with the option of a 2-year extension. In the case of Korea, a major element in resolving the crisis was the engineering of a "concerted rollover" and restructuring of interbank lines into sovereign guaranteed bonds, but with the help of a Korean Government guarantee. Another moral hazard was thereby created, in that foreign bankers might be induced to continue making short-term credit facilities available, supported by the knowledge that they would be able to enhance the quality of their claims with a State guarantee, if and when a crisis erupted — a crisis to which they would have contributed by making such short-term loans.

Turning to the lending or investing side of the equation, one example of moral hazard has been noted in the preceding paragraph: an incentive for less-than-one-year commitments by foreign banks, since the capital adequacy pre-

scriptions under the Basel Capital Accord required much lower ratios of capital to be reserved against shorter term claims (currently 20 per cent) relative to longer-than-one-year claims. And the bias towards shorter term credits applies with special force to developing countries that are not members of the OECD (which none are except a couple), since a 100 per cent reserving requirement applies to interbank claims exceeding one year in their case.

Illustrations of moral hazard on the lending/investing side arise primarily from assumptions that the financial authorities in the major money-centre countries will not permit the "rules of the game" to be changed adversely in the event of financial crisis. One such "rule", for instance, has been that holdings of sovereign bonds are not to be included in any comprehensive debt-restructuring operation. Another is that nonbank financial intermediaries, such as hedge funds, are not subject to disclosure of their commitments in over-the-counter markets for contracts in derivatives, and this is particularly true when they are established in offshore centres. Similarly, commercial and investment banks that enter into such contracts on their own account in off-balance sheet transactions are not required to reveal them either, except perhaps in terms of net (not gross) positions. Moreover, self-regulation through their own voluntary bodies is much preferred over official regulation in the case of institutions that are not critical to the payments and settlement process.

While these "rules of the game" might have been acceptable in earlier times, the growing range and complexity of financial products, and their continuing innovation, has generated a degree of opaqueness in the working of financial markets. This opaqueness suggests that very large risks can be taken — risks insufficiently known to or fully understood by the monetary authorities of even the major money-centre countries, let alone the authorities of the developing countries whose institutions might be holding the other end of such high-risk transactions. An event, such as the virtual bankruptcy of the Long-term Capital Management investment company in the U.S., casts a lurid light on the riskiness of the operations of a single, private hedge fund whose failure carried such horrendous consequences for global financial and commodity markets as to require the New York Federal Reserve to intervene to arrange its rescue. It is the unknown dimensions of the operations of such highly leveraged institutions that gives credence to the claims made by political leaders in some Asian countries (notably Malaysia) that their financial crises owed something to speculative actions of private offshore institutions that were not accountable for their activities. Moral hazard arose, in the first instance, in the failure to regulate and in the second instance, from an official intervention that gave assurance of support for the continuation of high-risk operations by private financial intermediaries.

One comes finally to the moral hazard implicit in the operations of the international financial institutions (IFIs). It has been argued that the massive intervention by the International Monetary Fund (in tandem with the U.S. Treasury) to deal with the Mexican crisis at the end of 1994 encouraged many short-term lenders to the Asian countries in the conviction that they would be "bailed out" by the IMF. As contagion spread from Thailand to Indonesia and onwards to Korea, the size of IMF support "packages" grew, respectively, from the equivalent of US$17.2 billion to $42.3 billion to $58.4 billion, thereby adding to the illusion that offshore investors could expect to escape the consequences of their misjudgements. Conservative public-opinion-makers in industrial countries were strengthened in their conviction that the "bailing out" applied to improvident debtor governments as well.

Neither set of convictions is entirely correct. Debtor governments have been traditionally allergic to using IMF resources because of the conditions attached to borrowing from it, which are regarded as an invasion of their sovereignty. Governments in East Asia that were regarded as highly successful managers of their economies were particularly sensitive to the loss of "face" and credibility in financial markets if they were to turn to the IMF for help. The failure to seek IMF help or even to take heed of IMF warnings in the period leading up to the Thai crisis illustrates the extreme reluctance to concede the option of an IMF presence in their decision-making. Hence, the availability of IMF resources could not have created moral hazard in the sense that it induced the Thai or other governments to act in imprudent ways in the knowledge that they would be "bailed-out" by the IMF.

While some elements in the lending community did manage their exposures in a way that allowed them to escape unscathed (e.g., short-term bank creditors), investors that are subject to "mark-to-market" rules of pricing should have known that they would suffer substantial losses if asset markets fell during a financial crisis. In many instances, the use of derivatives might have created a false sense of security for institutional investors, but precautions that are effective on an individual basis become useless if a crisis affects the collectivity. This was certainly proved to be true not only in the Asian countries directly involved, but in markets of other countries that were affected by contagion. The Institute of International Finance has estimated that portfolio investors suffered losses reaching US$350 billion in the succession of crises that started in East Asia and then spread to other parts of the world. Hence, much moral hazard has probably been squeezed out by recent experience.

Another element of "moral hazard", namely the implicit guarantee of pegged exchange rates, has been greatly weakened by the move of most crisis-affected countries to more flexible exchange rate regimes. Similarly, the failure of Long-term Capital Management has shaken

the previous trust of industrial country authorities in the efficacy of self-regulation. One preeminent concern in the ongoing discussions on reform of the international financial architecture is how to "bail-in" the private sector in situations of financial crises. The "rules of the game" may be changing even for sovereign bonds as, for the first time in its history, the Paris Club is calling upon an Asian country (Pakistan) to include Euro-bond holders in its "comparability of treatment" conditionality.

It has to be recognized that moral hazard cannot be eliminated altogether in any system that provides appropriate scope for private sector risk-taking. The crisis-affected countries of Asia can nevertheless take some satisfaction in the knowledge that their travail may have contributed to reducing the risks of moral hazard in the global financial system. ■

POLICY INSTRUMENTS FOR THE

Return of Private Capital TO Asian Countries

ROBERTO F. DE OCAMPO

Broader change and deeper reforms, not less, are called for to relieve Asia's economic distress. Since globalization is "inevitable and irreversible," trade liberalization, privatization, and deregulation should continue, avoiding wholesale protectionism. Recommendations are reviewed from APEC Finance Ministers for freer flow of capital and from the IMF for adjusted macroeconomic policies, together with measures for reducing debt, corruption and mismanagement, and building social infrastructure.

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LESSONS FROM THE ASIAN CURRENCY CRISIS

An economic tempest has blown through Asia. Its proximate causes and origins are still under debate. Key international organizations that have long shared a common policy framework appear divided on what should be done, and forecasts of recovery differ. On the eve of the new millennium, Asia faces the enormous task of restoring both growth and stability in each of its member economies. Fundamental economic and financial restructuring must take place for the region to create the conditions for a balanced, equitable and sustainable growth and development.

The extent of economic devastation in each Asian country affected by the crisis differs significantly according to specific national structural conditions and policy responses. These include:

1. the amount of international debt;
2. the proportion of short-term international debt;
3. the adequacy of financial sector regulation;
4. the amount of foreign reserves available to the monetary authorities;
5. the tenacity with which the country defended its exchange rate;

6. the extent to which IMF-style high interest rates and bank closing were implemented; and
7. the ability of the political system to preserve social stability while coping with economic shocks.

Certainly, there are profound and far-reaching lessons to be learned from the Asian currency crisis. First, sound macroeconomic fundamentals by themselves are not sufficient to achieve sustained economic growth. The Asian crisis has shown that structural factors play a decisive role in a country's economic and financial health. Second, deeper attention should be given to the institutional capacity of the financial sector and to the proper sequencing of financial sector reforms in order that developing economies may reap the benefits of an open capital account regime. Third, developing domestic capital markets is crucial to the growth of the region. A well-functioning capital market can mobilize long-term capital and encourage more efficient allocation of resources under market forces. Fourth, the Asian crisis calls for a review of the effectiveness of existing international multilateral financial institutions, as well as posing new challenges to the global financial system.

The Asian crisis started basically as a problem of liquidity. In this regard, a system that enables international financial institutions to buttress countries in distress with a sufficient amount of liquidity is essential so that the governments can concentrate on structural reforms, especially on restructuring their feeble financial and corporate sectors, without unduly contracting their respective real economies. There is also a need to prepare a global structure to monitor international capital flows, whose sudden and large-scale reversal has proven devastating for capital-recipient countries.

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The Asian crisis has also demonstrated that equitable growth and sustainable development require more transparent and participatory governance structures, both in the public and private sector. Should a "new" Asian development model emerge from the ongoing crisis, it will need to include such elements as a larger and more active role for civil society, innovative forms of public-private partnerships, and strengthened financial systems to facilitate capital account liberalization. These systems, in turn, require improved supervision and prudential regulation of financial markets, as well as efforts to deepen and broaden capital markets.

The ongoing crisis has changed, and is profoundly changing the business environment in the region, the terms in which the region is dealing with its key partners

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throughout the world, as well as the mindsets and perceptions within and outside the region. Nevertheless, a "new Asia" will gradually and, perhaps, painfully emerge from the crisis. But it will definitely be in a better position to play its role and take its share in the global economy of the 21st century. Undoubtedly, a healthier and reinvigorated Asia will ensue from the crisis. But we may ask:

- What will be the face, form and substance of the so-called "new Asia" after the crisis? What shall be its post-crisis financial infrastructure?
- Will the economic and financial restructuring lead to a "new Asian economic and development model"?
- How will the region face the challenge of good governance and of acquiring the software of globalization? What will be the scorecard of competitiveness in the region?
- On what terms, and to what extent, will Asia participate in a new and restructured global economy vis-à-vis its international partners and the international financial and economic community as a whole?
- What will be the effect and impact of a "new Asia" on regional cooperation, such as the Asia-Pacific Economic Cooperation (APEC) and the Association of Southeast Asian Nations (ASEAN)?
- What modalities should Asian banking and other institutional reforms adopt, at what pace, aiming for what results? What strategies should be adopted to cope with and manage tight capital? When and how will new financial instruments emerge? Will a so-called "new Asia" be able to achieve long-term and sustainable currency and fiscal stability?
- How will the information technology revolution and the knowledge-based economy reshape Asia, or mold the form and substance of a "new Asia"? What are its business, social and political implications?
- How will corporate restructuring and corporate governance impact on business prospects? How will the "new Asia" cope with its new consumer market?

These questions can help us think through not only what probably could have gone wrong in Asia in the past decade or so, but more important, determine what we need to prepare ourselves for in a new and more competitive global economy. Rather than engage in endless discourse about why and how the Asian crisis happened as it did, the more urgent task, especially for decision and policy-makers, is to identify challenges and prospects for bringing back renewed growth to their respective economies and to the region as a whole.

According to an economic theory, free movement of capital allows a more efficient global allocation of savings and directs resources toward their most effi-

cient use. Indeed, the theory has proven itself in practice. International capital flows during the 1990s grew dramatically, with transactions in bonds and securities growing rapidly in both developed and developing countries. Furthermore, the composition of these flows also changed significantly — that is, foreign direct investment (FDI) and portfolio capital flows replaced commercial bank lending as the main source of international capital flows. Unprecedented advances in technology primarily account for this surge in international financial transactions which resulted in the abatement of costs for market participants, privatization of State assets, deregulation of financial markets in key industrial countries, growth of institutional investors, and macroeconomic and structural reforms in developing countries. This new economic setting has encouraged institutional and private investors to hold a wide range of international securities, while financial innovations and international competition have made it difficult for countries to control international capital flows.

Recognizing the imperatives of economic globalization, a significant number of countries, also in the 1990s, began to adhere to open market policies and capital accounts liberalization. As markets expanded and technologies reached new heights, emerging or developing economies, especially in Asia, became among the most attractive financial destinations. Thus, a binge occurred between both lenders and borrowers, resulting in market bubbles. Notable among the causes of the subsequent bursting of these market bubbles are the absence of effective structures among Asian financial institutions and the lack of independence or quality of management to adequately cope with the massive sums of money that were being aggressively thrust upon them by eager foreign bankers and investors. Foreign bankers and portfolio investors lacked the knowledge, experience and sophistication to understand the environments in which they were operating.

A binge occurred between both lenders and borrowers, resulting in market bubbles.

ASIA BEYOND THE CRISIS

As fittingly expressed by Singapore's Ambassador-at-Large, Tommy Koh, the primary responsibility for pulling Asia out of its financial crisis lies with Asia itself. In the thick of the crisis, Asia is facing rising challenges ahead in its growth and development agenda. The critical and interrelated issues that need to be addressed include, among others, poverty reduction and alleviation, economic growth, financial sector development and environmental protection towards achieving equitable growth and sustainable development. Without sustained growth, poverty alleviation programmes fail, and the quality of life for a large proportion of the world's popu-

lation will be seriously impaired; incomes in developing countries could fall even further behind those in the world's more affluent economies. These outcomes would not only be socially and economically divisive, but also destabilizing from the perspective of peace and security. Ultimately, growth in the developing world is crucial not just for global economic prosperity but also for global peace and harmony.

Over the past several decades, Asia has demonstrated to the world that it can triumph over various difficulties and emerge from crises brighter and stronger. It has strong economic fundamentals, resolute willingness to save for the future, an unwavering determination to continue open market policies, and a mutual recognition of the importance of motivating labour forces and emphasizing education. These are factors which will help build a healthier and stronger Asia in the path of its recovery. The "Asian miracle" was and is not a mirage. In spite of the crisis, Asia remains largely pro-business in its outlook and policies, and, thus, still attractive for business and investment. In the midst of the crisis, the world can still find opportunities for growth and strategic alliances in Asia. The key challenge for the international development community in the near future is to maintain the pace and focus of these critical reforms even in the face of a cyclical upturn; while allowing effective social participation, efficient market interaction, and informed policy-making through reliable information dissemination.

The "Asian miracle" was and is not a mirage.

The outlook for the future of the region is not bleak at all. In fact, according to Alassane D. Ouattara, Deputy Managing Director, International Monetary Fund, the improving picture of Asia's future is due to the following factors, among others:

- The perseverance of the Asian crisis countries in pursuing stabilization and reform programmes;
- The easing of interest rates by most industrial countries, recognizing that the balance of global risks has shifted away from concern about inflation to a need for them to support growth;
- The adoption by Japan of new policy measures to stimulate domestic demand and tackle banking system problems with a view to reinvigorating its economy;
- The resistance of most countries to adopt protectionist and other market-closing measures, even in the face of competitiveness pressures and financial strains; and
- The measures taken by the international community to ensure that sufficient resources are at hand to assist countries in crisis.

The bottom line is, the clamour for reforms should address what businesses

The clamour for reforms should address what businesses need to perceive and be assured of: stability and predictability.

need to perceive and be assured of: stability and predictability. What is needed is a working, predictable political system; a reliable government; and a sound and stable banking and financial system.

SUSTAINABLE PROSPERITY FOR A "NEW ASIA" IN THE 21ST CENTURY: RECOMMENDATIONS

East Asia was a colonial backwater which suffered from centuries of wars and instability. Yet, it rose like a phoenix through intensive reconstruction, industrialization and interdependence with the larger economies: growth rates in the region soared and were generally acknowledged to be the highest and steadiest in the world. The region accounted for more than half of the world's growth in the past decade. No doubt, Asia will continue to be important to global strategists and to the world economy as a whole. The question is timing. Despite the diversity of the region's member-economies, there is convergence of interest among them, particularly in achieving sustainable economic growth and lasting social prosperity. Having been shaken by the crisis, Asia also needs to evolve a "new psychological paradigm" to counter self-defeating, sceptical mindsets that hamper the region's recovery. The region needs to overcome resistance to change, and instead restructure, not only for survival, but, most important, for long-term success. There also needs to be a collective resolve and political conviction among Asia's governments to resolutely undertake deeper reforms, innovations and commitment to social justice and interdependence. Social conflict and political unrest will negate efforts to achieve long-term and sustainable economic growth. Asia must now begin to move beyond defensive measures to innovative, breakthrough strategies, as well as devise more effective ways to enhance equity and efficient use of savings.

The world has a stake in the recovery of Asia. The entire global financial system is in jeopardy. Thus, global leadership has a shared responsibility in ensuring that the crisis in the region be abated as soon as possible, so that the task of rebuilding can commence forthwith. Asia's basic problem is clear and simple: shortage of cash flow due to illiquidity. The price of greater interdependence and deeper economic integration is inevitably that of shared risks and shared responsibility.

A consensus seems to be shaping up regarding reform strategies that need to be undertaken in order to relieve Asia from its present economic and financial distress and thus restore business and investors' confidence in the region, with the goal of achieving equitable growth and prosperity, and sustainable develop-

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ment. These strategies revolve around three main issues, namely:

1. macroeconomic policies;
2. structural reforms; and
3. the urgency of reviewing and reinforcing the global financial system.

Greater interdependence and deeper economic integration into the global financial markets require a high level of fiscal discipline. Since the collapse of the 200-year-old fixed exchange rate system in the early 1970s, exchange rate policies may be the most controversial and complex macroeconomic challenge in today's global markets. Of course, there is no single panacea suitable for all. Policy- and decision-makers must carefully examine the costs and benefits of alternative regimes. They should take into account the willingness of the political system to support adjustments through domestic demand, balance-of-payments trends, and the global environment. Perhaps they should adopt or maintain a more flexible currency exchange system that can be more resilient to, or withstand, the strains and shocks of the highly volatile global financial system.

Homework always begins at home. Asian governments must make more fiscally logical and defensible allocations of their assets. There must be a collective cognizance among Asian governments that, in carrying out reforms, in the struggle to regain positive growth in the short- and medium-term, they must work toward more political and economic transparency, as well as ensure political stability and food security for all its peoples. Again, social and political instability is one sure way of driving business and investors away from the region — even without a crisis.

There is no stopping the wave of globalization. Divergent views about world economics and finance are emerging, that is, whether or not globalization generates higher growth and prosperity or weakens national sovereignty and social cohesion. The debate, however, has shifted positively from appraising the costs of assent, to considering strategies that will more equitably regulate and distribute the benefits of a process increasingly being recognized as inevitable and irreversible. Thus, Asian governments must maintain their commitment to open markets, continuing trade liberalization and facilitation, and ongoing privatization, deregulation and stronger competition policies, as well as resist temptations to install wholesale protectionist measures.

By enacting and implementing clear, consistent, prudent and sound trade, investment and fiscal policies, in harmony with international guidelines, such as those provided by the World Trade Organization (WTO), Asian governments should be able to again attract foreign direct investments (FDI) and other

Asian governments must be bold enough to check the abuses of "crony capitalism".

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cross-border capital inflows, while, in the process, accumulating transfer of technology. Effective technology transfer is one of the best ways of equipping and preparing Asia's vast reservoir of human resources for an era where intellectual capital will be a key tool in advancing Asia's modernization and competitiveness.

Moreover, there must be a thorough review of, and the establishment of concrete standards for, all classifications of "governance" issues needed to regain investors' confidence. Asian governments must be bold enough to check various abuses associated with "crony capitalism". Only by restoring capital flows can Asia truly resume growth, and only by resuming growth can it reverse the major income losses that have caused widespread hunger and imperilled the livelihoods of so many people in such a short time. Improved governance must include:

- establishing strong prudential standards and supervisory procedures for the banking system;
- greater transparency in financial reporting standards and accounting requirements;
- improvements to many current opaque, and sometimes even vague, legal areas, such as more practical bankruptcy procedures and better mediation services; and
- stronger corporate governance standards and requirements. The legal underpinnings of corporate governance should be clarified, especially to protect minority shareholders. Part of the vulnerability to financial panic arises from the lack of clarity of property rights within the emerging/developing market economies.

The globalization process has exposed many long-standing practices and structures that are principal reasons for the susceptibility and weakness of the international financial system. In a world where capital can move suddenly and massively — with facility and ease, and, sometimes, even with impunity — structural patterns that are incompatible with global standards must be revised or abandoned if we are to reach a more stable phase of economic and financial integration. National authorities should address key structural deficiencies, while governments, multilateral agencies and market participants should articulate clear standards for sustainable participation in global finance.

Considering the virulence and global implications of the Asian crisis, regional multilateral bodies have, likewise, moved swiftly to consolidate reform efforts in the region. For instance, the APEC Finance Ministers have agreed on the following initiatives to facilitate increased private sector participation in infrastructure, promote the development of financial and capital markets, and support the freer flow of capital:

- Enhancing cooperation among export-financing institutions in order to maximize their catalytic role in attracting private funds

and in helping shape the region's economic climate to reduce risks while providing adequate return on investment;

- Strengthening financial market supervision in order to keep up with rapid changes in international financial markets;
- Strengthening clearing and settlement infrastructure;
- Supporting development of credit-rating agencies and strengthening information disclosure standards to help develop the region's capital markets and attract cross-border capital flows;
- Establishing a regional forum on pension fund reform to help boost domestic savings; and
- Establishing a regional forum on securitization as a viable mechanism for financing economic growth.

The Asian crisis highlights the importance of a sound macroeconomic policy framework, and the perils of having unsustainably large current account deficits. Beyond this, the International Monetary Fund (IMF) has identified six major areas where initiatives already underway should be strengthened:

- More effective surveillance over countries' economic policies and practices, facilitated by fuller disclosure of all relevant economic and financial data;
- Financial sector reform, including better prudential regulation and supervision;
- Ensuring that the integration of international financial markets is orderly and properly sequenced (supported by, among other things, a sound financial sector and appropriate macroeconomic and exchange rate policies) in order to maximize the benefits from and minimize the risks of international capital movements;
- Promoting regional surveillance;
- A worldwide effort to promote good governance and fight against corruption, including the adoption by the Interim Committee of the Board of Governors of the IMF on 16 April 1998 of the "Code of Good Practices on Fiscal Transparency — Declaration of Principles" to serve as a guide for members, and to enhance the accountability and credibility of fiscal policy as a key feature of good governance; and
- More effective structures for orderly debt workouts, including better bankruptcy laws at the national level and better ways at the international level of associating private sector creditors and investors with official efforts to help resolve sovereign and private debt problems.

Nonetheless, in spite of the foregoing backdrop, perhaps the most serious and pressing problem of the Asian crisis-countries remains the large amount of bad debts in their respective banking and cor-

porate sectors. Although a series of negotiations between the creditors and debtors has been initiated to restructure debts since 1997, there is much merit in curbing lending booms associated with capital inflows while addressing the underlying weakness in the banking system. The development of well-functioning capital markets will reduce risks of potential instability, as well as attract a growing pool of portfolio investment. Indeed, the volatility of short-term financial flows, especially in the advent of the information technology revolution, poses a formidable challenge for policy- and decision-makers. There is no simple or single solution to this dilemma. Yet, a combination in the following action-areas may provide some relief:

1. a sound blending of fiscal and monetary policies;
2. elimination of artificial incentives to short-term flows, as well as disincentives to long-term debt and direct investment flows;
3. reinforced risk management by investors and lenders;
4. shrewd measures that provide incentives for better asset and liability management practices;
5. increased disclosure; and
6. consideration of the need for supervisory arrangements for highly leveraged firms engaged in global finance.

However, the paramount long-term challenge for Asia is in building its social "software" or infrastructure, rather than in fiscal regulation, macroeconomic stability or exchange rate management. Asia's flawed social infrastructure and inadequate political institutions allowed for too much corruption and mismanagement. In an increasingly competitive world, where FDI and other cross-border capital flows are courted not only by Asia, but also aggressively by Central Europe and Latin America, concerns over governance are bound to heighten. That is why Asian governments must seriously and persistently invest in harnessing cutting-edge technologies and skilled manpower, as well as in setting up adequate social infrastructure and safety nets toward the goal of achieving equitable economic growth and lasting development and prosperity.

In the context of the Asian financial crisis, profound questions have been raised about the quality, transparency and responsiveness of the IMF to the financial problems faced by the developing countries. Likewise, questions have been raised regarding the balance-of-interests at play in global negotiations on environment, trade and capital mobility, among others. Are the developing countries truly represented or is their participation marginalized? Or, are the international negotiations run for and by the developed or industrialized economies, which represent a mere 15 per cent or so of the world's population? The intensification of criticisms against existing international, multilateral financial institutions has led to a demand for sweeping reforms, such as improved finan-

cial data, stronger supervision of banking systems, greater transparency and methods to ensure that private sector actors commit and stay where they are when things go wrong.

Perhaps, the proposal for the creation of a "G7+7" (to include the major emerging/developing markets/economies from each hemisphere) merits closer scrutiny and stronger support. Perhaps, too, this is one mechanism that could effectively broaden the democratic base and participation of developing nations in shaping world affairs and in deciding their fate for the next century — before the systemic risk to the world economy and the need to arrest the financial crisis gets any worse, if ever.

Nevertheless, regardless of the teeming debates about the subject and the extent of reform packages for the region, investors and capital will come to Asia only when they see very clear policy directions and a strong determination to pursue and put in place much needed reforms from its leaders. Asia needs to undertake a tremendous amount of re-engineering to better cope with a highly integrated and globalized economy. In the new economic milieu of the 21st century, Asian leaders need to be more open to change, more accepting of the need for greater interdependence and integration (as well as greater volatility), and committed to open management and far-reaching social development. In the end, the form and substance of the "new" Asia economic and development paradigm must bear a human face. ■

Creation of a "G7+7" could effectively broaden the democratic base and participation of developing nations in shaping world affairs and in deciding their fate for the next century.

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Managing Foreign Capital Flows in Chile

MARTIN KHOR & LEAN KA-MIN

Chile has adopted measures to prevent excessive capital movements (especially short-term capital inflows) that could damage the economy, build up foreign debts, channel funds into unproductive investments, and risk a debt crisis. At the same time, the policy is to curb national expenditure, keep inflation in check, maintain relative price stability, and promote export-led growth.

This possible model for other developing countries is described by Martin Khor, economist, author, lecturer and UN consultant, who is Director of the Third World Network (TWN), a grouping of non-governmental organizations, and by co-author Lean Ka-Min, who is a researcher with TWN.

INTRODUCTION

After the foreign-exchange drought of the 1980s debt crisis, external capital started streaming into several Latin American nations by the end of the decade. But this capital surge was not without its own set of problems in terms of its impact on these developing economies. While the problems posed by large foreign capital inflows are more or less the same for the recipient economies, measures to cope with the capital influx can run the gamut from a predominantly laissez-faire approach to the imposition of quantitative limits. This report examines the Chilean response to the capital surge, which can be considered to occupy a position somewhere between these two extremes.

Among Latin American economies, Chile is a favoured destination for foreign capital. As a share of Gross Domestic Product (GDP), total capital inflows into Chile averaged 6.2 per cent over the 1990-94 period. Arguably, just as important a consideration as the volume of capital flows is the composition of these flows. In this respect, while foreign direct investment (FDI) constitutes the single largest type of inflow into the Chilean economy, a significant portion of foreign capital has entered it in the form of shorter-term funds (Agosin & Ffrench-Davis, 1996).

The latter can essentially be divided into portfolio capital and short-term credits. Portfolio capital, in turn, comprises purchases of debt and equity securities such as stocks, bonds and money-market instruments. It is channelled mainly through foreign mutual funds and through offerings of shares of Chilean companies on the New York Stock Exchange via American Depository Receipts (ADRs) (Ffrench-Davis et al., 1995). Such investments are typically motivated by the prospect of short-term capital gains and are prone to bandwagon effects, be it in taking positions or in liquidating them (Agosin & Ffrench-Davis, 1996). As such, portfolio investments can hardly be considered as the most stable form of capital flow.

Portfolio investments and short-term bank lending look for quick capital gains, are prone to bandwagon effects, and are volatile and unstable.

Volatility also characterizes short-term bank lending, which is based on interest-rate arbitrage — buying low in one market and selling high in another. Such flows will come in only if and when the domestic interest rate exceeds the international rate by a margin sufficient to cover the expected depreciation of the recipient country's currency and the country-specific risk premium. When this condition ceases to hold, the funds can just as suddenly depart for more remunerative climes.

Chile has been exposed to the potential of such volatility. Foreign funds made a beeline for Chile from the late 1980s onwards. It therefore had to confront the problems associated with large capital inflows.

A major problem is that massive inflows of foreign capital within a short period of time bid up domestic asset prices beyond levels justified by the underlying economic fundamentals. This, in turn, through the positive wealth effect generated, leads to unsustainable increases in consumption and investment. Furthermore, a foreign capital surge entails real exchange rate appreciation as demand for the recipient country's currency rises.

It should be noted that much of the short-term capital flowing in is not actually channelled into real, productive investment but rather into speculative activities. Not only are these activities, by their nature, volatile and unpredictable, but they also do not contribute towards the recipient country's long-term economic development.

These speculative inflows often "produce their own gravediggers" as the resultant real exchange rate appreciation and increase in domestic demand cause a widening current account deficit. Along with the rise in external indebtedness, this situation adversely affects foreign capital's perception of the economy's general creditworthiness.

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Consequently, when an event triggers a change of investor opinion, foreign funds scramble for the exits, and the outflow is exacerbated by the herd mentality that characterizes international financial market players.

Many short-term capital inflows are not channelled into productive investment and long-term economic development, but into unpredictable speculation.

To make matters worse, these market agents are not always very sensitive to this risk and, as such, react only when it is too late, when the conditions have deteriorated to the extent that forced external adjustment of some magnitude becomes necessary (Le Fort & Budnevich, 1997). The overshooting of asset prices, aggregate demand, and the real exchange rate now occurs in the opposite direction, with potentially devastating effects on the domestic economy as the currency plunges alongside asset prices, with a resultant increase in the external debt overhang looming over the economy.

Such capital surges can further undermine domestic macroeconomic stability by throwing in doubt the feasibility of monetary policy. In the event of high inflation, tight monetary policy, which entails an increase in interest rates to curb excessive spending in the economy, would normally be called for. However, in an environment of unregulated capital flows, this interest-rate rise would lead to the influx of foreign funds attracted by the lucrative returns and greater potential for interest arbitrage. The capital surge, if left unchecked, can wreak damage upon the domestic economy. In short, the use of monetary policy to achieve such an important macroeconomic policy objective as price stability is more or less thwarted due to its impact on external capital flows.

The capital inflow has a chain of effects — the real exchange rate appreciation, which in turn has a negative impact on the recipient economy's competitiveness in international trade and, hence, its current account balance. This can be countered through intervention of the central bank in the foreign-exchange market, namely by buying foreign exchange. However, such intervention also serves to raise the domestic money supply, bringing about inflation. Once again, the conflict between the objectives of price stability and external balance manifests itself.

A possible solution to this policy dilemma could be in the form of sterilized intervention, where the central bank offsets the inflationary effect of the foreign-exchange-market intervention by selling government securities on the open market. Consequently, the central bank ends up holding assets that yield the international rate of return, and that

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depreciate in real terms while having to issue liabilities that pay the higher domestic rate and that maintain their real value (Le Fort & Budnevich, 1997). Thus, this measure cannot be sustained on a long-term basis, owing to the losses incurred by the central bank.

Another undesirable consequence of massive capital inflows to developing countries lies in how they heighten the vulnerability of the domestic financial system, which may not be all that well-developed to begin with. Due to the unpredictable nature of short-term capital flows and their being channelled into speculative uses — partly as a result of inadequate prudential supervision within the domestic financial sector — there is increased deposit volatility as well as foreign-exchange risk (Helleiner, 1997).

Moreover, the problem of moral hazard — arising from the tendency of economic agents to "perceive the existence of publicly provided insurance to liabilities of financial institutions and institutional investors, whether or not it has been explicitly offered" — further contributes to the assumption of greater risks (Le Fort & Budnevich, 1997). When the speculative bubble bursts, the financial sector will be in danger of going under, being saddled with a considerable stock of non-performing loans.

It is evident, therefore, that capital surges, while bringing in much-needed funds from abroad that can go some way towards financing a country's short-term economic development, can also wreak havoc on the domestic economy. Considering the shortcomings associated with foreign-exchange-market intervention, be it of the sterilized variety or otherwise, some form of regulation of these capital flows appears necessary to sift out the less desirable components of foreign capital while continuing to encourage the entry of long-term productive investments. In this regard, it might be instructive to examine the capital controls in place in Chile, to which we now turn.

Massive capital inflows to developing countries heighten the vulnerability of the domestic financial system, which may not be well-developed to begin with.

EXPERIENCE OF THE 1990S AND ITS MAIN FEATURES

In 1978-81, Chile experienced a period of large capital inflows. This period ended with the debt and economic crises. In 1982-87, there was instead a shortage of foreign exchange resulting from the debt crisis. From the late 1980s, there has been a return of foreign capital — a capital surge which brought with it a range of potential problems.

To deal with this, the authorities have adopted a number of measures. They had three main aims: to partially insulate the domestic economy from the impacts of

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capital inflows, to prevent too much appreciation of the currency (so as to protect the competitiveness of exports), and to maintain freedom and space for the implementation of domestic monetary policy.

Four basic instruments were used to neutralize any effects that the influx of short-term capital could have on the aims of Chile's export-driven growth strategy. These instruments are: (a) the application of taxes and reserve requirements to capital inflows; (b) an exchange-rate policy based on "dirty" floating of the exchange rate in relation to a reference value pegged to a basket of currencies; (c) open-market operations to sterilise the monetary effects of exchange-rate dealings; and (d) the prudent supervision of financial markets. These measures succeeded in moderating the exchange rate appreciation caused by the new capital inflows. Even so, there was a 15 per cent revaluation of the real exchange rate (Ffrench-Davis et al., 1995).

The first of the measures mentioned above has been rather unique, and this article will focus on it. It should be remembered, however, that in Chile, taxes and reserve requirements on capital inflows were accompanied by the other three measures, and thus a full understanding of Chile's strategy in regulating capital inflows would require a study of all the measures.

The Chilean system of reserve requirements and taxes is based on separating out the different types of capital inflows, including FDI, external loans and credits, and portfolio investment. It then imposes specific rates of reserves, and/or taxes, and/or a minimum-stay requirement on one or more of these inflows. The system has a bias in favour of longer-term and direct foreign investment, and it imposes higher costs on short-term inflows.

For FDI, the only important restriction is a minimum-stay requirement, under which such investment must be maintained in the domestic economy for at least one year. This applies only to the principal. Profits are generally not subject to this requirement, except from investment performed through debt conversion (Le Fort & Budnevich, 1997). The reason for not imposing a reserve requirement or tax is that the Chilean authorities would like to attract FDI, which is considered desirable in terms of its contribution to the economy's productive capacity, and the transfer of technology and management skills it engenders.

Other forms of capital inflows have been subjected to different rates of reserve requirements for different periods, and taxes introduced at different dates. The rates have also been varied as circumstances change, thus enabling policies to be flexible in accordance with changes in needs.

In June 1991, the authorities imposed a stamp tax on external loans at an annual rate of 1.2 per cent on operations of up to one year. This had earlier been in operation but applied only to domestic credit

(Agosin and Ffrench-Davis, 1996).

Also in June 1991, external credits were subjected to a non-interest-bearing reserve requirement of 20 per cent. The reserves had to be maintained with the central bank for a minimum of 90 days and a maximum of one year. This meant that the impact fell mainly on short-term flows (Agosin and Ffrench-Davis, 1996).

In July 1991, an alternative to the reserve requirement was allowed for medium-term credits. In lieu of maintaining part of the funds with the central bank, medium-term borrowers may pay to the central bank an amount equivalent to the financial cost of the reserve requirement. This cost is calculated by applying the London Inter-Bank Offered Rate (LIBOR) plus a specified spread to the amount of the reserve requirement. The margin above LIBOR was fixed at 2.5 per cent as at July 1991.

According to Agosin and Ffrench-Davis (1996): "The reserve requirement, the option of paying its financial cost and the tax on foreign credits all have a zero marginal cost for lending that exceeds one year, and are particularly onerous for lending at very short maturities."

In 1992, the authorities wanted to increase domestic interest rates in order to maintain macroeconomic stability. As they did not want to attract increased capital inflows when implementing this policy, in May 1992 they decided to raise the reserve requirement on external credits to 30 per cent. In October, the central bank increased to one year the period for which time deposits in foreign currency had to be maintained, regardless of the maturity of the loan. At the same time, the spread charged over LIBOR in the option of paying the financial cost of the reserve requirement was raised from 2.5 to 4 per cent.

In the middle of 1995, there were further pressures towards currency appreciation. To stem these pressures, in July 1995, the central bank extended the 30 per cent reserve requirement to foreign financial investments into the country, particularly for purchases of Chilean stocks by foreigners (through American Depository Receipts –ADRs).

Thus, by the second half of 1995, there was in place a 30 per cent reserve requirement on almost all forms of foreign capital inflows. Its coverage included external loans and bonds issued abroad, external credit lines used to finance trade operations, foreign-currency deposits and portfolio investment. The exception was FDI, which was only subjected to a one-year stay requirement.

On top of these, limits were placed on certain portfolio capital inflows such as bonds and ADRs, which represent the acquisition of shares of domestic companies by foreigners. These instruments can only be issued if the amount to be raised comes to at least US$25 million. Furthermore, issuers must meet a classification of long-term debt risk of BBB or better for non-financial companies and BBB+ or better for banking institutions (Le Fort & Budnevich, 1997).

In the first half of 1998, the situation regarding capital flows changed. From the middle of 1997, some East Asian countries had suffered from a deepening financial and economic crisis. This had a significant effect on Chile as an important part of its exports are to the Asian region. From the latter part of 1997, the Chilean peso dropped against the US dollar. Thus, from a situation where there were pressures for revaluation, there now developed a reverse situation of pressures towards depreciation.

In response, in June 1998, the financial authorities reduced the reserve requirement for capital inflows from 30 per cent to 10 per cent. This reduction shows that the policy can be implemented flexibly to suit changing conditions. In a period of excessive inflows, the ratio can be maintained at a higher level, or raised; and in a period where greater inflows are desired, the ratio can be reduced.

These measures all serve to increase the cost of external financing and particularly to discourage excessive inflows of funds that have a short-term orientation — the ones which are the most volatile and potentially damaging. Given that the reserve requirement involves a one-year deposit regardless of the duration of the investment, the shorter the term of the inflow, the greater is the implied cost.

In terms of revenue, the Chilean authorities receive a stamp tax on foreign loans, interest paid by borrowers of foreign funds in lieu of meeting reserve requirements, and the central bank's earnings on the interest-free reserve requirements. Up to 1994, the estimated revenues were US$355 million, comprising tax on foreign loans, $110 million; interest in lieu of reserves, $121 million; and interest earned, $124 million.

Implementation of the capital-market regulations is the responsibility of the Chilean monetary authorities. The administration of the reserve requirement is handled by the central bank, Banco Central de Chile, in which the reserve requirement funds have to be deposited. Details of the system of capital-account regulations in place in Chile can be found in a paper by two officials of the Banco Central — its Deputy Director of Research, and its International Director and Manager of Financial Analysis (Le Fort & Budnevich, 1997). The Banco Central is also responsible for interventions in the foreign-exchange market as well as sterilized interventions in order to stabilize the real exchange rate under the managed-float system (see below).

PROBLEMS ENCOUNTERED AND HOW THEY WERE OVERCOME

Until recently, the basic problem in implementing the above measures was that they were not adequate to stem the capital surge, and therefore regulations had to be strengthened in the ways described above.

Apart from direct regulations imposed on foreign capital inflows, exchange rate

policy has also been employed by Chile. The aim has been to discourage short-term speculative flows by introducing a greater element of uncertainty into the equation. Chile operates a managed floating exchange rate system within a band, and the flexible interventions of the central bank in the foreign-exchange market, coupled with monetary sterilization operations, to help in moderating the effects of the capital inflows on the real exchange rate.

For example, in early 1991, the exchange rate of the Chilean peso was moderately revalued on three occasions and then, in compensation, devalued in the following months. Such a measure introduced exchange-rate "noise" as the real devaluations within each move made it more costly for short-term funds to enter the country (Ffrench-Davis et al., 1995).

Also, in 1992, the official benchmark rate's peg to the US dollar was replaced with a peg to a basket of currencies comprising the dollar, the Deutschmark and the yen. This was in order to deter interest-rate arbitrage, given the daily instability of the international prices among these three currencies (Ffrench-Davis et al., 1995).

However, the Chilean monetary authorities were recently confronted with a problem of a diametrically opposite nature as a result of the ongoing East Asian financial crisis. Instead of being inundated with a capital deluge, the Chilean economy this time around had found foreign capital increasingly hard to come by and had to cope with a falling peso (Mark, 1998). Chile, which has developed close trading links with many Asian "tiger" economies, saw demand (as well as prices) for its exports founder as these economies were hit by depreciating currencies and torpid, or even negative, growth. This unfavourable trade situation was exacerbated when Japan, the biggest Asian buyer of Chilean exports and Chile's second-largest trading partner, also became afflicted with the economic malaise.

In response to this, as already noted above, the reserve requirement ratio was reduced in June 1998, from 30 per cent to 10 per cent in order to encourage more capital inflows into the Chilean economy and thus support the peso (Gonzalez, 1998).

EFFECTS OF THE MEASURES TAKEN

A major aim of Chile's capital-market regulations has been to discourage excessive inflows of certain forms of capital, whilst retaining the flows of long-term direct investment. As noted by Le Fort and Budnevich (1997): "The effectiveness of the reserve requirement can be also seen from the change of the composition of net capital inflows. Increasingly, external financing has been moving from debt to direct investment and equity-based portfolio investment. This implies a more flexible structure of financing, favouring risk-sharing between domestic and external partners. At the same time, medium- and long-term forms of debt have gained

ground and represent increasing proportions of total debt financing."

Measured in terms of percentage of GDP, FDI and longer-term portfolio investment have grown in importance compared to foreign borrowing. Net foreign investment plus portfolio investment picked up from around 3 per cent and 1.2 per cent of GDP in 1990 and 1991 respectively, to 2.5 per cent and 4 per cent in the two subsequent years. Even in the case of foreign borrowing, the share of medium- and long-term debt has increased relative to that of short-term financing. In 1994, short-term financing was equivalent to 2.4 per cent of GDP, a decline from its 1990 level of 4.6 per cent (Le Fort & Budnevich, 1997).

This movement towards relatively more of the longer-term, more stable inflows can be attributed to the regulations' inherent discriminatory bent against short-term funds. The shorter an inflow would stay, the more costly it becomes to place a portion of the funds in a one-year non-interest-bearing deposit account with the central bank, and to pay a fixed annual stamp tax of 1.2 per cent.

Thus, the aim of checking the inflow of volatile short-term funds without jeopardizing the entry of FDI, seems to have been realized through Chile's imposing its regulations on incoming capital. Given that the internationalization of the Chilean stock exchange is only just beginning, the ability of these regulations to put a damper on funds with a short-term orientation may well become integral to preserving domestic macroeconomic stability in the face of globalized capital.

With respect to using monetary policy as an anti-inflationary tool, the regulations have also proven their worth to policy-makers. A tight-money stance has been maintained without prompting an influx of foreign funds. As a result, inflation has been reduced from almost 30 per cent in 1990 to 9 per cent in 1994, with average short-term real interest rates of 6 per cent per annum — higher than developed-country standards (Le Fort &Budnevich, 1997).

Bearing in mind the potential pitfalls involved in drawing conclusions from a naked-eye inspection of economic data, it is worth noting that in the 1990s, Chile has enjoyed higher or steadier GDP growth than Mexico and Argentina which, in contrast to Chile, have gone down the path of greater capital-account liberalization. While initially the Mexican inflation rate was lower than Chile's, a massive capital flight subsequently befell Mexico, leading to a drastic depreciation of its currency and sending Mexican price levels soaring way above those in Chile (Agosin & Ffrench-Davis, 1996). Although such comparison is hardly a rigorous analysis, it suggests that capital-account regulations shield the economy from wild fluctuations brought about by large-scale short-term capital inflows and outflows, and help maintain a stable economic environment in which government macroeconomic policy can proceed unhampered.

Pursue this comparison further and look at Mexico's cumulative current account deficit, an indicator of financial sustainability. Over the period 1991-94, it was 25.4 per cent of GDP — two-and-a-half times greater than Chile's 10.4 per cent. "Even though the volume of foreign capital inflows in Chile as a share of GDP was quite similar to that in Mexico, Chile effectively used a much smaller amount"; this was a result of the reserve requirement and the stamp tax consuming quite a sizeable proportion of the inflows (Agosin & Ffrench-Davis, 1996).

This issue of a sustainable current account deficit is, in turn, related to the real exchange rate. The extent of currency appreciation should be controlled so as not to adversely affect competitiveness in international trade and to correspond to a sustainable current account deficit. However, empirical evidence strongly suggests the inability of the reserve requirement to affect the real exchange rate in any significant manner in both long- and short-term (Edwards, 1998).

Indeed, the reserve requirement does not prevent speculative attacks arising from expectations of exchange-rate adjustments. This is because its implied financial cost is insufficient to offset the capital gains that can be made from the change in currency value. As a result, "despite the reserve requirement, only exchange rates that are consistent with market expectations can be successfully defended. The equilibrium trend of the exchange rate, even if it represents a significant real appreciation of the currency, cannot be influenced by such policies. An exchange-rate adjustment can be spread more over time, but only to a certain extent" (Le Fort & Budnevich, 1997).

However, whether the reserve requirement is effective should not be judged by a goal it was not meant to achieve — defense of a fundamentally unsustainable exchange rate. The more modest objective of the reserve requirement is to prevent wild fluctuations around the rate's equilibrium trend so as to avoid the drastic and painful adjustments associated with such swings.

Capital-account regulations shield the economy from wild fluctuations and help maintain a stable environment for macroeconomic policy to proceed unhampered.

It did contribute to real exchange rate stability. There was no unduly large, potentially destabilizing capital inflow into Chile, such as could lead to initial overshooting of the exchange rate in the direction of appreciation. In view of the positive interest-rate differential with respect to the industrialized economies, a capital surge might well have materialized if there had been no such controls and if no costs had been imposed on capital inflows (especially short-term ones).

But Le Fort & Budnevich (1997) go

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on to assert: "The fact that the appreciating trend of the Chilean currency has continued at about the same rate after the introduction of a reserve requirement is not an indication of the ineffectiveness of this tool. The reserve requirement allows for maintaining an interest-rate differential in favour of the emerging economy without having to generate an expectation of currency depreciation to fulfill the arbitrage condition. That is to say, the reserve requirement is successful if a once-and-for-all currency appreciation followed by a depreciating trend is avoided. An appreciating trend could be the result of financial pressures rather than a trend in the equilibrium exchange rate; and rather than indicating weaknesses of the reserve requirement itself, such a sustained trend shows the strength of the existing capital-account regulations, including the reserve requirement.... One should expect from such measures no more than a contribution to efforts aimed at keeping the current account deficit within reasonable bounds and at sustainable levels, while domestic macroeconomic targets of growth and price stability are attained."

Thus, viewed in the light of its designated objectives, the Chilean reserve requirement (and the capital-account regulations as a whole) can claim a significant degree of success.

Moreover, the regulations do bring in some revenues to the State — US$355 million since the scheme started, up to 1994, as already noted. The amount is not very large, and Agosin and Ffrench-Davis (1996) conclude that these policies should therefore be judged by their prudential and regulatory value, rather than as revenue earners.

Nevertheless, such measures do have their downside as well. For one, the cost of capital to domestic economic agents will have increased for three reasons. They now have to borrow more than is required for their intended use in order to comply with the reserve requirement (or, in lieu of that, pay the financial-cost equivalent). The stamp tax is an added item of expenditure. In addition, borrowers whose foreign loans are for less than a year incur an opportunity cost by having to maintain their interest-free deposit with the central bank for the full one year.

This imposes a heavier burden on domestic economic agents. Also, it actually has a distorting effect on the financial market. Large firms, which have access to international finance and know how to circumvent the regulations, are likely to remain relatively unscathed. However, small and medium-size firms are left to bear the brunt of the more onerous domestic borrowing rates (Edwards, 1998).

By effectively limiting the integration of the domestic system into global financial markets, Chile's capital-account regulations also limit portfolio diversification by domestic economic agents. If such investors could have a wide range of assets in their portfolios, from both the domestic sector and abroad, they would minimize their risk. They would be less

subject to the vagaries of a single domestic economy. The resulting increase in domestic income stability could compensate for the national income volatility arising from the variability of individual export prices which affects open economies (Le Fort & Budnevich, 1997).

It should be evident that these regulations interfere with the free running of the capital market. Consequently, questions of inefficient resource allocation will arise. However, the markets themselves, unlike their textbook incarnations, are far from being efficient. For example, imperfect information, bandwagon effects and a myopic orientation towards short-term capital gains characterize the operations of portfolio investors. Furthermore, looking at the speculative uses of much short-term capital in emerging markets (in the real-estate sector and the stock market, for instance), it becomes clear that, in many respects, the financial markets have become divorced from the real production economy.

Hellyer (1998) points out that the volume of foreign-exchange transactions in the global financial system, amounting to around US$1 trillion a day at present, has increased fourteen-fold since the 1970s while world trade has little more than doubled. He goes on to declare: "[The world financial system] is in cyberspace and programmed to ignore the real needs of the vast majority of the world's population still in need of food, clothing and shelter." Unfortunately, though, when the entire fragile financial edifice collapses, the real economy — and the real people in it — do suffer, as the experience of the Latin American and Mexican crises and the ongoing East Asian crisis amply demonstrates.

In such a volatile environment, the need for at least some form of capital-market regulation, such as Chile's, can best be appreciated. The regulations were meant to stem the inflow of volatile short-term funds, and largely achieved the goal. Against this background, it may seem inconsistent that the reserve requirement was recently reduced in order to attract more inflows due to the effects of the East Asian crisis on Chilean trade.

The world financial system is in cyberspace and programmed to ignore the real needs of the vast majority of the world's population still in need of food, clothing and shelter.

Rather than discrediting the entire notion and rationale of the reserve-requirement system, however, this move actually points to the flexibility such a regulation affords in managing the capital account. The reason for discouraging excessive short-term inflows to begin with is to avoid the instability and drastic adjustments forced on the domestic economy as a result of swings in the direction and volume of these flows. If a high reserve requirement ratio is used to

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prevent undue real exchange rate appreciation, which would eventually be destabilizing, then, by the same token, lowering the ratio to counter an unwanted depreciation which has equally destabilizing consequences is warranted.

As well, it is worth repeating here that the Chilean capital-market regulations do not include "drying up the capital account" as one of their objectives. Of course, it could be contended that, given their demonstrable effectiveness in Chile, if such capital controls had been in operation in the East Asian economies in the first place, the financial crisis might not even have erupted (or, at least, not on such a damaging scale).

Therefore, the value of the Chilean measures lies in there being a set of possible policy measures that governments of developing countries can take to avoid the volatility of short-term capital inflows and outflows, and thus prevent the kinds of major financial crises that have recently afflicted many countries.

SUITABILITY AND POSSIBILITY FOR UPSCALING

A "cleaner" alternative with respect to regulating foreign capital inflows is the Tobin tax, a tax on all international transactions, be they trade-related or capital-market transactions. Like the Chilean regulations, the Tobin tax, which takes the form of a uniform rate, imposes a substantial disincentive on short-term flows, while the cost incurred in relation to long-term flows is almost negligible. "The reason is that payment of a, say, 0.25 per cent tax on a 10-year investment represents a negligible fraction of the principal earnings. By contrast, on an overnight round trip, it would eat up the profits except on investments with extremely high returns" (Dornbusch, 1997).

However, the Tobin tax constitutes an improvement on the current Chilean controls in that the potential for evasion is less. The latter cover only financial transactions and, as such, evasion is possible to the extent that the intended inflows can be channelled through transactions which fall beyond the ambit of the regulations. Such evasive measures may include underinvoicing imports or overinvoicing exports, delaying import payments or accelerating export receipts and bringing in funds through the informal foreign-exchange market (Agosin & Ffrench-Davis, 1996). The Tobin tax, on the other hand, applies to all cross-border flows and not merely to financial transactions.

Of course, because of its comprehensiveness, the tax imposes a cost on trade transactions as well but, again as with the case of long-term financial transactions, this is likely to be negligible for any single goods or services transaction. Furthermore, it is precisely the result of its broad application to all foreign-exchange transactions, and hence its relative simplicity (out of not having to discern between different types of cross-border flows), that the Tobin tax entails fewer administrative burdens and lower costs on the levying authorities, compared to

the imposition of something like Chile's reserve requirement (Dornbusch, 1997).

Finally, even with regard to FDIs, the possibility of instituting measures to regulate their inflow cannot be discounted. After the underinvestment of the debt-crisis years, foreign investors, through a characteristic process of stock adjustment, have headed back to the region — Chile being a prime destination — in order to attain their desired levels of FDI stock. In the process, these large inflows may pose absorption problems for the host economies in terms of possible overheating and the resultant macroeconomic adjustment.

Moreover, FDI flows are themselves not free from volatility. Being the supranational behemoths that their name suggests, transnational corporations regularly engage in "international intrafirm financial transactions to respond quickly to changing national circumstances." They manage liquid funds as well as flows of real goods and services, and they usually do so very effectively. Foreign direct investors can also, when appropriate, borrow from foreign or domestic financial institutions in pursuit of their international financial-flow objectives (Helleiner, 1997).

As a result of these characteristics, some form of regulation of FDI inflows might not be out of place. (Note that these regulations are discussed only in relation to capital volatility and absorption; the issue of regulations that are more directly related to domestic development, such as conditions on domestic content, employment of locals, technology transfer and so on, is beyond the scope of this report.) Agosin & Ffrench-Davis (1996) put forth some possible measures, such as auctioning FDI rights, placing investment applications on an informal queue or selecting among those projects on offer only those deemed most likely to contribute towards domestic development. "All these options entail a much more pragmatic approach to FDI than the uncritical embrace of recent years."

POLICY SIGNIFICANCE AND TRANSFERABILITY TO OTHER COUNTRIES

The Chilean system has significance for developing countries which wish to better manage the interface between external financial forces and domestic macroeconomic and financial objectives. In view of the present financial crisis, which has spread from East Asia to other parts of the world, the Chilean policies assume even greater significance and are now often quoted as examples of prudent management.

The Chilean policy recognizes the need to distinguish between long-term and short-term capital inflows, and the potentially harmful movements of short-term flows, and devises practical mechanisms to reduce their volatility. The main policy significance, therefore, is that the measures help prevent excessive capital movements that could damage the economy, build up foreign debts, channel funds into unproductive investments, and risk large withdrawals of short-term

funds and a consequent debt crisis.

The measures also enable a country to have better control over its financial and macroeconomic policies. As we have seen, a prime objective behind Chile's capital-market regulations is to enable effective implementation of monetary policy. Without constraints on foreign capital inflows, a tight monetary policy needed to control domestic inflation, through its effect of raising interest rates, will not be feasible due to the massive capital influx that will result. In this regard, Chile's regulations can be considered a success. They allow for high interest rates and a positive interest-rate differential with respect to the developed world. The effect is to curb excessive national expenditure and hence keep inflation in check. In turn, this ensures that relative prices generally remain stable and thus do not adversely affect or distort resource allocation and sustainable growth.

By contributing towards a more stable real exchange rate and a more sustainable current account deficit, regulations like Chile's facilitate the pursuance of economic policy that is geared towards export-led growth. Indeed, the growth and diversification of exports has become the engine of growth of the Chilean economy. For example, in 1995, exports grew by 11 per cent in real terms, compared to real GDP growth of 8.5 per cent (Le Fort & Budnevich, 1997).

While the capital-market regulations have played, and continue to play, their part in avoiding the volatility that comes with unfettered financial liberalization, it should also be necessary to strengthen the domestic financial system. This is to enable it to perform its intermediary role more effectively in terms of more efficient resource allocation and reducing the prospect of channelling funds rashly towards activities that would generate speculative bubbles.

Towards this end, more and better prudential supervisory mechanisms need to be put in place, to supplement and go hand-in-hand with the capital-market regulations. As Devlin et al. (1995) put it: "[E]ffective [prudential] regulation will require countries to improve their monitoring systems for external capital flows. This must be done not only at the microlevel for individual financial institutions, but also at the macrolevel to ensure that the volume and composition of flows are consistent with economic stability."

Given the globalized nature of financial capital, and the potential damage it can wreak on a recipient economy, developing countries would do well to study the Chile capital-account regulations, an in particular the reserve requirements and taxes on capital inflows.

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cial capital, and the potential damage it can wreak on a recipient economy (especially short-term, speculative funds), developing countries would do well to study the Chilean capital-account regulations, and in particular the reserve requirements and taxes on capital inflows. The need for some form of capital control is even more acute for the smaller developing economies (where the absorption problem is heightened) and those with a less-developed domestic financial sector.

The frequency and severity of the financial crises which have recently afflicted several developing economies and regions indicate the danger of letting capital surges go unchecked. Accordingly, the need for measures to regulate the flow and composition of foreign capital comes to the fore. The aim is to preserve stability and sustainability, while going some way towards ensuring that foreign funds, instead of causing a recipient economy to veer off its development path, play their part in facilitating the growth process.

The Chilean policies could well be considered as options to be adapted and implemented in other countries wishing to reduce the impact of their exposure to volatile international financial flows. ■

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Globalization of Finance & Development Prospects in Africa

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Trade liberalization, market-oriented policies, fiscal restraint and more efficient state machinery are essential in sub-Saharan countries. But such measures will not alone overcome currently poor development prospects and achieve poverty-reducing growth. It is also necessary domestically to mobilize savings, invest in physical infrastructure, produce an educated labor force, and provide for stable legal, political and commercial transactions, and externally to obtain debt relief and attract foreign investment. Nguyuru H. I. Lipumba, Tanzanian Economics Professor and Presidential Candidate (1995), argues for both a better mix of growth-promoting national actions and a greater volume and better terms of international aid for the region.

INTRODUCTION

Many countries of sub-Saharan Africa (SSA) have been implementing structural adjustment programs supported by the World Bank and the International Monetary Fund (IMF). These economic reforms include macroeconomic stabilization, liberalization of trade and financial markets, privatization of public enterprises and establishment of stock exchange markets, partly aimed at opening African economies to attract capital inflows. There is a clear commitment to market-oriented reforms by an increasing number of African governments which have formally accepted obligations of article VIII of the IMF Charter; it prohibits them from restricting payments and transfers for current account transactions and engaging in discriminatory currency arrangements.

Extensive restrictions of this type were the norm in the first half of the 1980s. In 1985 only two SSA countries had accepted article VIII obligations. By January 1999, at least 34 sub-Saharan African countries had done so. Some countries, such as Uganda, have liberalized both current account and capital account transactions, and have repealed foreign exchange controls. Nigeria is the only major country that drastically reversed liberalization of the foreign exchange market; it fixed its exchange rate in 1993 and has been operating a dual exchange rate regime until early 1999.

Following IMF advice, many countries have enacted laws that increase the autonomy of the Central Banks to pursue the objective of price stability. Despite adopting market friendly policies, most SSA countries have been bypassed by the surge in private capital inflows to developing countries during 1990–97. These countries have large external debt payment arrears and face a debt-overhang problem that discourages domestic and foreign investment.

Sub-Saharan Africa continues to depend on official development assistance that has sharply decreased in the past four years. The adoption of market-oriented reforms has not been supported by increased assistance. The end of the cold war has not produced a peace dividend to support broad-based growth and human development; instead, it has been associated with widespread aid fatigue in developed countries.

If SSA countries are to significantly reduce poverty and meet targets of the Copenhagen Social Summit of halving the number of the poor by 2015, they need to grow by 6–8 percent per year. The economic and institutional framework for sustained, broad-based growth is not yet in place. For the sub-Saharan region as a whole, growth of per capita income was negative in 1985–94. Though IMF researchers have characterized economic growth in 1995–97 as a turning point in the region, it was only one percentage point higher than the growth rate of population. It is both too low to make a dent on poverty and too fragile to be considered as a takeoff to sustained high growth. The increase in non-oil commodity prices in 1994–95 contributed to the recovery, but private investment did not significantly increase. The collapse of commodity prices emanating from the Asian financial crisis has reduced growth in 1998 to less than the population growth rate.

ECONOMIC GROWTH, INVESTMENT REQUIREMENTS AND PRIVATE CAPITAL MARKETS

Sustained high growth requires an educated and healthy population, and an enabling institutional framework that provides incentives to individuals, households and firms to be productive. Investment in physical capital is a necessary though not a sufficient condition for high growth rate of output. All fast-growing East Asian countries had average annual investment rates of 20 to 30 per cent of GDP during the 1960–92 period, as measured by purchasing power parity prices in the Penn World Tables. By comparison, average annual investment rates in African countries have been low — less than 5 per cent in ten countries (Angola, Burundi, Chad, Ethiopia, Madagascar, Mozambique, Rwanda, Sierra Leone, Uganda and Zaire). Another 13 countries had investment rates of 5 to 10 per cent (Benin, Burkina Faso, Cape Verde, Central African Republic, Congo, Gambia, Ghana, Guinea, Malawi, Mali, Niger, Somalia, and Tanzania). The only

countries with investment rates of around 20 per cent — similar to those of China, Hong Kong, Indonesia and Thailand — are some of the mineral-exporting countries, including Botswana, Gabon, Namibia, South Africa and Zimbabwe.

The low level of investment rates is partly explained by the fact that domestic savings, which normally finance a large share of domestic investment, are very low. In most cases, African countries have decreasing saving rates, particularly compared to East Asian economies. Low per capita income does not completely explain low rates of saving — for example, low income in China and India is not associated with low saving rates. In Sub-Saharan Africa what has contributed to the low saving rates is economic stagnation and negative growth rate of per capita income.

Another reason for low levels of domestic saving rate is the weak financial system. Financial institutions in most countries of the region have not been performing the role of effectively mobilizing savings and channeling resources to highly productive investment. In almost all countries except South Africa, Mauritius and Zimbabwe, the financial sector is underdeveloped, thin and shallow. Financial sector reforms sponsored by the World Bank and IMF are rooted in the theory of "financial repression". Poor investment and growth are seen to have been caused by negative interest rates, high reserve ratios, and directed credit that has lowered domestic savings and misallocated credit to projects with lower returns. The reforms have emphasized the liberalization of interest rates that should lead to positive real deposit and lending rates, ending of directed credit, restructuring/privatization of state-owned banks, easing of government restrictions and controls on entry into the financial sector by foreign and domestic institutions, and strengthening of the bank regulatory framework.

Governments have been encouraged to establish competitive markets for government short-term debt instruments such as treasury bills. The purposes are to remove financial repression, finance budget deficits in a non-inflationary manner, and introduce indirect instruments for the conduct of monetary policy. Financial repression has been seen as a major cause of low saving rates in less developed countries. However, empirical works that show negative real interest rates associated with low saving rates fail to distinguish between small and large repression. Countries with large negative interest rates drive regression results that show significant positive elasticity of saving rates with respect to interest rate. When these countries are excluded from the sample, real interest rate loses its statistical significance.

It should be noted that high negative interest rates are the result of high inflation, a symptom of government failure not only to collect taxes and control expenditure, but also to deliver govern-

ment services and maintain the rule of law. Where the government is excessively inefficient, saving rate and growth are likely to be low. Increasing the nominal interest rate to make the real interest rate positive is unlikely to increase the saving rate and promote growth. High interest rates may exacerbate the financial position of weak governments because of increases in government debt servicing.

Before liberalizing interest rates to promote saving and efficiency in investment allocation, economic reforms should focus on improving the government fiscal discipline. African financial markets are highly fragmented, with the majority of the population in rural areas and the informal urban sector having no access to financial services. If savings are to be effectively mobilized, financial services have to be extended to the population that is currently underserved. This requires innovative ways of linking the formal and the informal financial sectors by encouraging the development of emerging semi-formal intermediaries. The problem of lack of access to credit facing small holder-farmers and small and medium scale enterprises cannot be resolved by opening the financial sector to international commercial banks such as CitiBank. International banks can worsen credit availability of local firms by out-competing domestic banks in the lucrative business of well-established enterprises. Domestic banks may be confined to the more risky and less profitable customers, reducing their capacity

The problem of lack of access to credit facing small holder-farmers and small and medium scale enterprises cannot be resolved by opening the financial sector to international commercial banks such as CitiBank.

to expand credit. Financial restraint that includes setting nominal interest rates that make real interest rates only slightly positive and directing credit to competitive sectors such as exports is more appropriate for sub-Saharan African countries at their stage of development.

According to the World Bank, the prerequisites for complete financial integration into the global capital markets include:

- sound macroeconomic framework, particularly strong fiscal position and absence of debt payment arrears;
- a functioning market system and absence of large price distortion
- sound domestic banking system with adequate supervisory and regulatory framework
- a functioning market infrastructure and regulatory framework for capital markets.

Most African countries do not meet these preconditions.

Reducing inflation to single digit levels close to those prevailing in OECD

countries is an important policy objective for countries interested in integrating in the global financial markets. However, it is too costly to fight inflation using high interest rates. Most SSA economies do not have in place a competitive financial sector. Market-determined interest rates are most likely to be influenced by collusive behaviour of a few, in most cases less than four, financial institutions that usually account for over three-quarters of the assets of the formal financial sector. Using auctions of treasury bills to establish the benchmark interest rates can lead to high real interest rates for a long period, choking private sector activity and investment in the real economy. Real interest rates of over 10 or even 20 per cent have been common among countries that prematurely try to introduce market-based interest rates before adequate measures are taken to control budget deficits. High yields on treasury bills and government bonds not only crowd out credit to and investment in the private sector; they undermine the development of financial institutions' skill in risk analysis and selection of good projects and entrepreneurs in the private sector. High yields on treasury bills and bonds may attract short-term capital inflows. With floating exchange rates this will lead to the appreciation of the exchange rate, penalizing exports and encouraging imports. Capital inflows may be followed by capital outflow when foreign interest rates increase or in anticipation of future exchange rate depreciation. Large instability in the real exchange rate is not conducive to the creation of conditions to support sustained growth of exports. Central Banks need to focus on maintaining a competitive and stable real exchange rate. If they focus on using interest rates to fight inflation, they will undermine the growth of export and import competing sectors.

Africa still requires development finance to build its physical and social infrastructure. Private markets are unlikely to provide it.

Stabilization and adjustment programs have reduced public investment without increasing private investment. To increase and sustain poverty-reducing growth, SSA countries need increased levels and efficient allocation of investment. Increased public investment in infrastructure is necessary to attract productive private investment. The current average gross investment rate of 17 percent is not adequate to sustain average growth rates of 6 to 8 percent. Africa needs gross investment rates of 25 to 30 percent to develop the social and physical infrastructure and provide the private sector capital requirements for sustained, poverty-reducing growth. Even with prudent fiscal and monetary policies, domestic savings are unlikely to be adequate to

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finance necessary investment. International financial institutions laud global financial integration as providing emerging and developing economies with access to global financial markets, more productive investment, and modern technology to accelerate their economic growth and modernize their financial systems. But even before the East Asian financial meltdown, African countries were unable to attract large amounts of private capital inflow. Foreign direct investment is attracted to countries that have good physical, institutional and human infrastructure. Huge public investment is a prerequisite for attracting private investment.

Africa will continue to need official development assistance. Private capital flows as a share of total resource flows have been decreasing in sub-Saharan Africa but increasing in all other developing regions. The experience of African countries with private capital flows varies across the region. The CFA zone countries used to receive a large share of their resource inflow in the form of private capital flows. After the debt crisis in the early 1980s, private capital flows declined and stayed low even after the 1994 devaluation. For example, in Côte d'Ivoire, private sources used to account for over 60 per cent of resource inflows from 1970–1984, but since 1984 have reached less than 3 per cent. Kenya's total capital inflows also used to include a large share of private flows in the 1970s, but they decreased in the 1990s to an average of less than 3 per cent. Despite the shortage of capital in sub-Saharan countries, capital inflows have been limited.

Foreign direct investment is concentrated among the developed industrialized countries and only a few emerging economies. The United Nations World Investment Report 1998 estimates that in 1997 the developed countries accounted for 68 per cent of the stock of inward foreign direct investment. In the 1990s, the share of emerging and developing economies has increased from 20.6 percent in 1990 to 30.2 percent in 1997. The whole of Africa, however, accounted for only 1.9 percent of inward investment in 1997, compared to 3.1 percent in 1985 and 2.2 percent in 1990. During 1990–96, sub-Saharan Africa accounted for less than 3 per cent of the total foreign direct investment to all developing countries; this was despite the fact that rates of return on foreign direct investment in sub-Saharan Africa averaged 24 to 30 per cent, compared to 16 to18 per cent for all developing countries (Bhattacharya, Montiel and Sharma 1997, World Bank 1997).

Most foreign direct investment is in natural resource extraction, particularly petroleum. Foreign direct investment to Nigeria, almost all for the petroleum industry, accounted for 60 per cent of all foreign direct investment to sub-Saharan Africa during 1990-95. The next largest recipient was Angola, accounting for 16 per cent of the sub-Saharan

total during 1990–95, also mainly in petroleum. Other major recipients include Ghana, with 6 per cent of the sub-Saharan total, largely as the result of the privatization of the Ashanti Gold Mines. Zambia accounted for 4.6 per cent of the total, mainly as a result of privatization of the copper mines.

In the 1970s, a few countries such as Nigeria, Côte d'Ivoire, Gabon, Kenya, Congo Republic, Congo (Kinshasa) and Cameroon had access to international commercial bank loans. The developing country debt crisis that started with Mexico in 1982 also affected most of these countries; they lost access to new loans from commercial banks; old loans were not rolled over and had to be repaid, causing a net transfer of resources to foreign commercial banks. Angola, Mauritius and South Africa are the only countries that have significant access to external commercial bank loans. Other countries' net flows from commercial banks have been negative. However, if we include official bilateral and multilateral debt flows, most SSA countries had positive net resource transfers on debt throughout 1970–95. The exceptions include Nigeria, Côte d'Ivoire, Gabon, Kenya, Congo Republic, and Congo (Kinshasa). Most SSA countries are not in a position to access commercial bank loans, including long-term syndicated bank loans that can be used for infrastructure investment. This is because they lack credit worthiness and have large arrears on debt payments. Such arrears exceed a billion dollars for 14 countries (Angola, Cameroon, Congo Republic, Congo (Kinshasa), Côte d'Ivoire, Ethiopia, Liberia, Mozambique, Madagascar, Nigeria, Somalia, Sudan, Tanzania and Zambia). Debt payment arrears exceed annual export earnings in 12 countrires (Angola, Congo Republic, Congo (Kinshasa), Equatorial Guinea, Ethiopia, Guinea-Bissau, Madagascar, Mozambique, Nigeria, Sao Tome and Principe, Tanzania and Zambia).

Foreign investment in African stock markets is still quite small. This is partly because only a few stock markets are fully operational and liberalized to allow unhindered participation of foreign investors, particularly institutional investors that have become increasingly important in world capital markets. Among SSA countries only 7 countries had received foreign portfolio investment at least in one year during 1992–96 period (Botswana, Côte d'Ivoire, Ghana, Mauritius, Nigeria, South Africa and Zimbabwe). South Africa is the largest recipient of equity flows. It is the tenth largest market in the world in terms of capitalization value, although its trading ratio is not highly ranked. Ghana is also a major recipient (see box).

Virtually all sub-Saharan African countries, except South Africa and Mauritius, do not have access to the international bond market. The causes of declining shares of private capital inflows to sub-Saharan Africa include low economic growth and small markets,

unconducive policy environment, weak institutions and debt overhang. Until recently African countries have not been attracting investment, even in the extractive industry such as mining, with the exception of petroleum drilling. In other developing countries, particularly East Asia, a large share of the private flows are invested in export oriented manufacturing industry or finance infrastructure in export-oriented economies.

Africa is increasingly dependent on official flows and receives the largest share of grants to all developing countries. Overall foreign aid has been decreasing. In 1997 industrial countries offered less aid as a proportion of their national income than any time since comparable data started being compiled in 1950s according to OECD. Aggregate official flows to all developing countries are decreasing in nominal and real terms. In 1994 to 1997 official development assistance to sub-Saharan Africa fell by 20 percent in real terms, even when more countries were implementing market friendly reforms.

With the end of the cold war, the United States has drastically reduced development assistance to all countries except Israel, a high-income country. US multilateral contributions have been decreasing. Continuous Congressional delays in disbursing funds are undermining the burden-sharing principle among donors. At the time of negotiations of the eleventh replenishment the International Development Association (IDA-11), the US was in arrears on payments due to IDA-10 by almost a billion dollars.The decreasing US commitment to multilateral development institutions is the main cause of the one-third fall in commitments in IDA-11 compared to IDA-10. The IDA loans are highly concessional because they are paid over 40 years following a ten-year grace period.These loans are interest-free except for service charge of 0.75 percent. The IDA loans have more economic value than bilateral loans because they are least tied.

African countries should design policies that foster macroeconomic stability, build institutional capability in government, maintain transparent rules of the game and provide incentives for private sector investment. The region still requires development finance to build its physical and social infrastructure. Private markets are unlikely to provide the requisite finance. International development financing institutions need to have more resources. Alternative methods of increasing the resources available to IDA are needed. The World Bank should consider tapping the international capital market using donor-financed interest subsidies that will reduce the cost of borrowing, a method similar to IMF's financing of Enhanced Structural Adjustment Facility (see Killick 1998, Sanford 1997). A club of reforming African countries that have initiated growth, but need additional investment, should lobby the World Bank and donors to subsidize

LEGENDARY GOLD, MODERN CAPITAL FLOWS

In recent years, Ghana has become a significant recipient of equity flows. In particular, this occurred as a result of the privatization of the Ashanti Gold Mines and its listing in the New York Stock Exchange.

Ghana's own stock market, established only in 1990, is the second largest in terms of capitalization. Equity flows accounted for 66 and 51 per cent of total private flows to Ghana in 1994 and 1995 respectively.

Such large flows are not likely to be sustained because privatization of other enterprises is unlikely to attract as much interest as the legendary Ashanti Gold fields which gave Ghana its colonial name of the Gold Coast. The low world price of gold seems to be lasting, and the defeat of inflation in industrialized countries dampens foreign interest in the gold market.

interest payments and enable countries that are performing well to have access to finance in the private capital markets through the World Bank.

AFRICA NEEDS ADEQUATE DEBT RELIEF AND MORE DEVELOPMENT FINANCE

In the 1990s Latin American countries that formerly were highly indebted regained their credit-worthiness and had access to commercial bank loans. African countries are still shunned by commercial banks partly because of high indebtedness and debt payment arrears. Before the 1997 currency and financial crisis, medium-term syndicated bank loans were considered as an important source of private financing for infrastructure investment in middle-income countries in Asia. After the crisis, flows of bank loans to developing countries have turned negative. Private capital flows in general and bank loans to developing countries in particular are highly sensitive to international interest rates. External loans to developing countries are likely to be more available during the downswing in the business cycle of the industrial countries and will be difficult to arrange during the upswing. In the current American boom, inflation rates and interest rates have remained low. If the US can sustain robust growth over a long period with low inflation, interest rate may remain low "permanently".

In such an environment of moderate access to syndicated bank loans improving export-oriented infrastructure in African countries that have gained credit-worthiness should be considered. Only a few countries have debt-servicing obligation of less than 15 per cent and hence have their credit-worthiness intact, including Botswana, Lesotho, Mauritius, Namibia, Seychelles. The only sub-Saharan African countries that have access to

the syndicated bank loan market seem to be Mauritius, Seychelles, South Africa and Swaziland.

Resolving the debt crisis is a prerequisite for building African credit worthiness in the medium and long term. Among the 41 heavily indebted poor countries, 33 are from sub-Saharan Africa. For over a decade, these countries have undergone debt-rescheduling exercise after adopting stabilization and adjustment programs supported by IMF and World Bank. The external indebtedness of these countries has increased after three, four or five debt-rescheduling exercises that have undermined the integrity of the whole exercise.

The World Bank and IMF have sponsored a Highly Indebted Poor Country (HIPC) initiative that is supposed to resolve the remaining debt problems of the low-income countries. This initiative involves a commitment by bilateral and multilateral creditors made at a decision point after a country has a three-year track record of being in the good books of the IMF and the World Bank. The commitment is to reduce the debt burden of eligible countries to sustainable levels, provided the country completes a further three-year period of strong policy performance. Thus, before debt reduction can be effected, a highly indebted poor country has to have six continuous years of good track record. The World Bank and the IMF consider the debt to be sustainable when the net present value of debt to exports ratio and debt service to export ratio are below a country-specific target within ranges of 200–250 per cent and 20–25 per cent, respectively. In the special case of highly open economies that have high debt burdens relative to fiscal revenue, the definition of "sustainable" is that the net present value of debt should not exceed 280 per cent of fiscal revenue (Boote and Thuge 1997).

The debt sustainability measures do not focus on the fiscal crisis of African governments. Debt sustainability should be determined by the ability of government to raise funds to pay debt, while providing necessary infrastructure and social services, and without imposing enormous tax burdens on the private sector that will discourage investment. Sachs (1996) has suggested that African countries can start growing fast if they do four things: strengthen the rule of law; lower the highest marginal tax rates to 20–30 per cent; adopt uniform tariff rates of 10 per cent; and limit government expenditure to 20 per cent of GDP. As a rough guideline, he suggests allocating 5 per cent of government expenditure to education, 3 per cent to health, 2 per cent to public administration, 3 per cent to army and police, and 5 per cent to government investment, mainly in road infrastructure and particularly rural roads.

This type of minimalist expenditure on essential areas leaves no revenues for debt servicing. Many African countries, including the favoured reformers, are

unable to raise 20 per cent of their GDP in fiscal revenues. The unending rescheduling of external debts with new arrears being accumulated after the end of every Paris meeting has damaged the integrity of budgetary process of African governments. It is impossible to have serious government budgeting and prioritization of government expenditure when you allocate 20 to 40 per cent of government revenue to debt servicing and still accumulate external debt payment arrears. The external debts of Africa were contracted under single party or military governments. Many African governments have been moving, in most cases grudgingly and under pressure from western donors, towards pluralistic democratic systems. Newly elected governments need to take bold measures to impose fiscal discipline, reduce runaway inflationary pressure and establish a conducive and level playing field with supporting infrastructure to encourage private sector investment. A debt overhang will make it impossible to carry out economic reforms and will undermine political stability of democratically elected governments.The six-year waiting is longer than the normal political cycle of five years. A newly elected government faithfully implementing reforms cannot show that its external indebtedness has been reduced to sustainable levels at the end of its term in office and before the next election. Many countries that have been implementing reforms will not celebrate the new millennium with sustainable external debt levels.

By the end of 1998, the IMF and the World Bank had agreed debt relief under the Highly Indebted Poor Country (HIPC) initiative to seven countries in Africa (Uganda, Burkina Faso, Côte d'Ivoire, Mozambique and Mali) and two others (Bolivia and Guyana). Only Uganda and Bolivia have benefited from HIPC debt reduction in 1998. Mozambique and Mali may receive debt reduction in 1999, Burkina Faso in 2000, Côte d'Ivoire in 2001. Ethiopia, Tanzania, Niger and Zambia will not qualify until 2002–2003. A modest funding of the IMF debt reduction measures by selling a small part of the IMF gold was strongly opposed by Japan and the previous CDU administration in Germany. After the unfolding of the East Asian crisis, the IMF and the Group of Seven countries mobilized more than $100 billion and bent the country-quota-related rules to prevent an Asian financial meltdown. The IMF is having problems raising $7 billion needed to implement the HIPC initiative in more than 20 African countries.

The failure of the club of the rich nations to extend debt write-off to highly indebted poor countries imposes pain by restricting the ability of governments to extend health and education to the poor. It also undermines their ability to prepare for selective and prudent integration in the global capital markets. African countries need debt relief to pro-

mote private investment, attain sensible tax and expenditure policies and foster integrity in fiscal and financial systems.

Debt cancellation should not be conditional on having an agreement with the IMF and the World Bank. Linking debt cancellation to IMF approval undermines ownership of the reform process. Market-oriented reforms that are accompanied by institution-building with broad-based political support can initiate long-term growth, but there is no evidence that IMF programs have initiated sustained growth anywhere in Africa. Moreover, IMF policies are not always appropriate. Under IMF pressure many countries have liberalized interest rates by auctioning treasury bills in thin markets before reducing fiscal deficits. As a result, the domestic cost of debt servicing has skyrocketed, worsening government finances. Yet a government that refuses to liberalize interest rates will not reach an agreement with the IMF and will fail to qualify for a debt reduction.

In most sub-Saharan African countries, external debt was contracted to finance projects proposed and designed by foreign experts selected by donor aid agencies or the World Bank. Many of these projects proved to be white elephants. Increasingly, African countries have realized policy mistakes of the past and have implemented far-reaching economic reforms. There is, however, a lack of humility among the donor community and multilateral aid agencies that most of the projects with costly inappropriate technology were imported from Western countries at their insistence and advice. Their private companies profited from exporting equipment and consultancy services, without taking the risk of success or failure of the investment. Both African governments and Western aid agencies are jointly responsible for the African debt crisis. In these circumstances the morally right thing to do is to wipe the slate clean. Write off all the debt of low-income African countries and make new aid available only to those countries that have right policies for long-term development, the protection of human rights and democratic transition.

Debt cancellation should not be conditional on having an agreement with the IMF and the World Bank, which undermines a country's ownership of the reform process.

The IMF dismisses unconditional debt cancellation because it will promote moral hazard problems. It is argued that creditors will not lend again to recipients of such cancellation. Why should countries that have misused resources more than others have more of their debt cancelled? What guarantee is there that the money saved would be put to effective use? Most of the loans to

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Because both African governments and Western aid agencies are jointly responsible for the African debt crisis, it is morally right to wipe the debt slate clean. Then make new aid available only to countries with right policies for long-term development, protection of human rights and democratic transition.

countries such as Mobutu's Zaire were motivated by strategic cold war calculations of western powers who knew the money was not being used to promote development. Why should the Congolese citizens who suffered under the Mobutu kleptocracy be responsible for paying the external debt that Mobutu deposited abroad and squandered with the full knowledge of the creditors? Why does the IMF ignore the moral hazard on the creditor side? If creditors that provided loans to government with wrong policies and institutions do not lose their money, they will improve their lending policies.

In any case a large fall in concessional loans to Africa has occurred when more African countries are adopting market-oriented reforms. Countries that have governments opposing economic reforms do not service their external debt and accumulate payment arrears. Their misuse of resources is not affected. It is governments that are interested in reforms that are bound to service their debt. Governments interested in implementing economic reforms have to allocate their scarce technical and administrative manpower in negotiating debt rescheduling instead of designing programs to initiate and sustain poverty-reducing growth. Even the HIPC debt cancellation is not deep enough and does not lead to debt levels that are sustainable.

The IMF calculations of debt sustainability use assumptions that are too optimistic. I therefore support the 1998 UNCTAD Trade and Development Report proposal that an independent body should be selected to review the debt sustainability of the highly indebted low-income countries.The IMF pretends to have policies that promote high quality growth that leads to poverty reduction. Economic development is a do-it-yourself process. External capital inflow, foreign ideas and technology transfers are important in facilitating economic growth. They can, however, only complement and not replace domestic effort in understanding, adapting and managing development policy. The fundamental causes of the African debt crisis are foreign donors, motivated either by good intentions or cold war politics, and African governments which tried to find shortcuts and avoid the "do it yourself" process that is necessary for economic progress.

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IS UGANDA'S DEBT "SUSTAINABLE"?

Uganda was the first country to receive debt cancellation under the Highly Indebted Poor Country (HIPC) initiative of the International Monetary Fund. Over time, it is expected to reduce Uganda's external debt by US$ 650 million — 20 percent of its nominal value.

IMF concludes that the Uganda's debt is now sustainable. Projections are that its debt- servicing ratio will decrease to an annual average of 14.5 percent in 1998 to 2001, compared to 22.2 percent in 1995 to 1998. This reduction can be attained if exports in dollars grow at an annual average rate of 15.4 percent in the next three years. However, such export growth seems too optimistic, given that commodity prices are weak and that Uganda's annual growth rate of exports was only 0.4 percent during 1986 to 1996. The optimistic projections seem to be based on the unusual export performance of 1994 and 1995, when there was a coffee price boom and good weather conditions led to a bumper coffee harvest.

Uganda tax collection is around 10 to 11 percent of GDP. The export GDP ratio is still low — around 12 percent of GDP. A debt-servicing ratio of 15 percent implies using 1.5 percent of GDP or 15 percent of tax revenue to service debt. Can Uganda afford to service its debt and invest in poverty eradication? Without continued development assistance, Uganda will not be able to service its debt.

For Uganda, donors have been quite sympathetic. Pledges of providing almost a billion dollars in aid in a year's time were made at the end of 1998. These levels of aid may be needed for at least the next five years for Uganda to avoid unsustainable indebtedness after the HIPC debt cancellation.

A STABLE GLOBAL FINANCIAL SYSTEM WILL SUPPORT DEVELOPMENT IN AFRICA

Sustained economic growth in Africa depends on robust growth of the world economy. Although the financial system of most African countries, except South Africa, is not integrated into the global financial system, their economies are not insulated from the fallout of global financial crisis. Financial crisis and low growth reduce demand for SSA commodity exports, and lower their prices and foreign exchange earnings. Decreased world demand for all products makes it difficult for SSA to diversify their exports. The minuscule private capital flows to SSA countries fall during financial crisis. African countries will benefit from a stable global financial system that promotes growth, international trade, for-

eign direct investment and transfer of technology. It is in the interest of Africa to have a global financial system that is stable and promotes sustainable growth of the world economy.

Sustainable global growth is good for African growth. Designing development policies to promote exports and attract foreign investment is more feasible in a world where major currencies have relatively stable exchange rates. A stable global financial system will reduce the use of international public resources to bail out private financial institutions and crowd out development finance to poor countries. Emerging African economies can benefit in having access to finance in a stable system. Africa needs more foreign direct investment, not only in extraction of natural resources, but also in export-oriented manufacturing. Liberalization of capital account transactions is, however, not necessary for promoting foreign direct investment into Africa.

To take advantage and benefit from opportunities of globalization and mitigate adverse impacts of the global current requires effective and capable state machinery. Getting beneficially integrated in a global economy is not automatic once you remove trade and investment barriers. It requires an educated labor force and enabling environment that promotes learning as a life-long activity. It depends on having a good physical infrastructure, particularly for transport, telecommunication, power and water supply. It necessitates an institutional framework which promotes the rule of law and stable rules of the game for commercial transactions. The rule of law requires institutional arrangements that effectively implement the laws of the land, protect the security of individuals and their property, adjudicate disputes, and provide orderly succession of power.

As Polanyi argued, markets are sustainable only in so far as they are embedded in social and political institutions. Widespread perception of legitimacy of economic outcomes is necessary for maintaining political stability. Globalization is not sustainable if it significantly erodes that perception. It is a myth to think that a country can attain prosperity by simply opening its markets. Globalization does not nullify the need for development strategy — a purposeful action by the state to mobilize and motivate economic actors to initiate and sustain poverty-reducing economic growth. There is no single development strategy relevant to all countries regardless of their initial conditions. Globalization has made designing country-specific development strategies more difficult because of policy convergence promoted by international financial institutions.

All countries are required to move towards free trade regimes and convertible currencies. Financial markets have to be liberalized and interest rates have to be market-determined. To attract foreign direct investment, tax rates on profits must be low and government revenue should increasingly be dependent on

consumption taxes such as value-added taxes. The current wave of promoting trade liberalization and the condemnation of state interventions in the economy is based on what Rodrik has characterised as market fundamentalism — myths and half truths that freeing up international markets is the surest way to global prosperity. It is ahistorical to assert that the necessary and sufficient condition for the initiation and acceleration of economic growth and structural transformation is to have sound money, open markets and the protection of property rights. Historical evidence from both developed market economies and the newly industrialized countries does not show automatic economic development once a country has adopted a free market regime. Laissez-faire free markets are neither necessary nor sufficient for triggering and sustaining economic growth and structural transformation. If the objective of a less developed agrarian society is to undertake industrialization and the transformation of its economy to a modern one with high labour productivity and good standards of living, it should not expect that market forces would accomplish this objective. If economies of scale are important and imperfect information abounds, the market cannot allocate resources efficiently to promote structural transformation.

For latecomers, a necessary condition for industrialization is a systematic and well-coordinated government intervention to promote manufacturing investment and supportive infrastructure. Learning by doing is a vital aspect of the development process and the realization of a country's constantly evolving, potential comparative advantage. The new rules of the World Trade Organization preclude the use of industrial policy that carefully combines market forces and selective intervention to protect infant industry. A liberalized import regime for consumer goods tends to have a demonstration effect, which promotes consumption and discourages saving. The corporate saving rate is likely to be high in an import regime which promotes investment in equipment and machinery, but discourages the importation of consumer goods. The ethos of an emerging industrial bourgeoisie could be influenced by public policy that promotes investment and discourages conspicuous consumption.

Historical evidence does not show automatic economic development once a country adopts a regime of laissez-faire free markets. They are neither necessary nor sufficient for triggering and sustaining economic growth and structural transformation.

To promote and sustain development in a globalized world, SSA countries need capability of implementing "market ori-

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ented" planning to adapt the local economy to opportunities offered by the global economy. The government must have the capacity to formulate and implement a set of coordinated policies that will mobilize domestic savings, offer stable and attractive incentives to promote investment and provide public goods needed for broad based growth. International rules such as those of the WTO and wrong-sequenced financial liberalization constrain the emergence of market-oriented "development states" in Africa, and may undermine initiating the development process and integrating SSA countries into the global economy in a way that will be beneficial to its citizens. ■

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Current trends, perspectives and events

Windows ON THE SOUTH

NEW UNDP ADMINISTRATOR AND ASSOCIATE ADMINISTRATOR NAMED

MARK MALLOCH BROWN, WORLD BANK VICE-PRESIDENT, TO HEAD UNDP

MARK MALLOCH BROWN was confirmed on 23 April 1999 by the UN General Assembly to succeed James Gustave Speth as Administrator of the United Nations Development Programme (UNDP), following his nomination by UN Secretary-General, Kofi Annan.

Mr. Malloch Brown has been Vice-President for External Affairs and Vice-President for United Nations Affairs at the World Bank since 1996. He joined the World Bank in 1994 as Director of External Affairs. He is credited with having helped the Bank to enhance its outreach, expand its partnerships with other UN agencies and non-governmental organizations, build stronger links with client and donor countries, and strengthen its media outreach and strategic communications worldwide.

Speaking about his new job, Mr. Malloch Brown said: "This is a wonderful homecoming for me; I began my career in the United Nations. I arrive with a keen and long respect for UNDP and its staff. I also come with a sense of urgency because, in a rapidly changing and globalizing world, the mission of UNDP must continue to evolve. The problems of poverty and inequality persist. We

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need to find new weapons to fight old wars. Let me also say I am very proud to take on where Gus Speth is leaving off. He leaves me a strong platform, based on the extensive managerial changes and new focus that he has introduced into the organization, and I am deeply grateful to him."

Before joining the World Bank, Mr. Malloch Brown was the lead international partner, from 1986-1994, in a strategic communications management firm, the Sawyer-Miller Group, where he worked with corporations, governments and political candidates. His varied career includes service with the United Nations High Commissioner for Refugees (UNHCR) from 1979-1983. His work in UNHCR included an assignment in Thailand where he was in charge of field operations for Cambodian refugees. From 1981-1983, he served as Deputy Chief of the Emergency Unit in Geneva.

Mr. Malloch Brown founded *The Economist Development Report*, a monthly review of the aid community and the political economy of development. He served as the Report's editor from 1983–1986. Before that, from 1977–1979, he had been *The Economist's* political correspondent.

Mr. Malloch Brown was educated at Magdalene College, Cambridge University, where he received a First Class Honours Degree in History. He also holds a Master's Degree in Political Science from the University of Michigan.

Mr. Malloch Brown will assume his new duties as Administrator on 1 July 1999. ■

NUMBER TWO POST GOES TO ZEPHIRIN DIABRE, FORMER FINANCE MINISTER OF BURKINA FASO

United Nations Secretary-General Kofi Annan, after consultation with UNDP Administrator James Gustave Speth, has appointed MR. ZEPHIRIN DIABRE as Associate Administrator of UNDP.

Mr. Annan said that Mr. Diabre represents a new generation of African leaders with strong management skills as well as development and political experience. "I look forward to his contribution to the United Nations," the Secretary-General added.

Mr. Diabre is an alumni of Ecole Supérieure de Commerce de Bordeaux. Soon after he completed his doctorate in Business Finance, Mr. Diabre took over as Head of the Business Department at the University of Ouagadougou. After serving as Member of Parliament and holding several ministerial positions in the government of Burkina Faso, including Minister of Finance, Economy and Planning in Burkina Faso, and as Minister of Trade, Industry and Mines, he was appointed Visiting Scholar at the Harvard Institute for International Development and Fellow of the Weath-

erhead Centre for International Studies in 1997.

Mr. Diabre's last assignment, before he took over as Associate Administrator of UNDP on 15 January 1999, was Economic Adviser to the President of Burkina Faso. ■

BUSINESS AND INVESTMENT COLLABORATION BEING MAPPED BETWEEN AFRICA AND ASIA

What can African and Asian business executives do to increase Asian foreign direct investment in Africa?

This was the question when 32 regional and international experts recently met to plan the launching of a new Africa-Asia Business Forum. Their consultations covered the possible structure and content of the Forum and selection criteria for the countries, industries and businesses to be targeted.

The Business Forum will bring together business executives from Africa and Asia to negotiate a variety of agreements, including joint ventures, franchising, licensing, subcontracts, technology transfers, etc. A project proposal estimated at US$1.8 million is under consideration, with the source of funds being Japan's Human Resources Development Fund.

The experts meeting, organized by the Special Unit for TCDC, was held from 10 to 13 February 1999 in Glen Cove, Long Island. The group included representatives from the private sectors and Chambers of Commerce in Africa and Asia, the multilateral financing community (the Multilateral Investment Guarantee Agency MIGA: Promote Africa and the World Bank), UN system partners (UNCTAD and UNIDO), the Government of Japan, and the UNDP focal points for TICAD II and the private sector. TICAD II was the second Tokyo International Conference on African Development, held in October 1998, where the proposal for the Forum was endorsed. ■

A NEW WIND-UP RADIO FOR THE POOR

For millions of families in developing countries, access to information is a luxury. In Africa for example, there are fewer than 50 radios per 1,000 people. For families in rural areas without electricity, a radio that requires batteries is an extravagance few can afford.

A British inventor, Trevor Baylis, came up with the idea of a wind-up radio when he was watching a television documentary about the difficulties of educating people on HIV/AIDS in remote parts of Africa. It is called the Freeplay Radio.

South Africa perfected key components of the radio to make it more marketable. It needs no electricity or batteries, only a little "elbow grease" to manually crank up its handle. The radio

can play an hour at a time. With support from the Liberty Life Foundation, villages without electricity or sufficient books started using the radio as a simple, cost-effective way to bring special programming on health, environment, news and education to thousands of adults and children.

The radios are manufactured by ex-prisoners, who gained their skills through South Africa's National Institute for Crime Prevention and the Reintegration of Offenders, which is supported by the United Nations Development Programme. ■

SHARING IDEAS

COOPERATION SOUTH is devoted to critical analysis and discussion of development issues of importance to the South. To this end, it welcomes the exchange of ideas and experience from all sectors, disciplines and viewpoints, and from sources ranging from policy-makers and scholars, to practitioners and community activists.

Readers wishing to take an active part in this dialogue are invited to comment on articles published in the journal and to contribute articles for possible publication. Letters and manuscripts, which are subject to editing, should be sent to the Editor-in-Chief, Cooperation South, as follows:

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"The Asian financial crisis is not necessarily a bad thing"

BY TUENJAI DEETES

Western ideas — like democracy or free market capitalism — have been changing the foundations of Thailand's mainstream society. Ten years ago, the formal government wanted to change Thailand from a primarily agricultural country to an industrial country that would be the fifth "Asian tiger." But we could only be that fifth tiger by importing the technology from the First World. Many of the people from the rural areas went to the city to work in the factories, and now our Thai songs actually talk about this migration.

We are a Buddhist society, and Buddhism teaches people to live in harmony with nature, to give more than to take, and to be pure in spirit. Modernization has encouraged people to receive more than give, to collect more money for their own benefit.

Our king has challenged this modernization in light of the Asian financial crisis. In his birthday speech, which he delivered last December fourth, he said, "It is not

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important to be an economic tiger. What matters is that we have enough to eat and to live. A self-sufficient economy will provide us with just that. It will help us to stand on our own and to produce enough for our consumption." He also said if only a quarter of the country could change course and turn from a market-based to a self-sufficient economy, we would survive the economic slowdown.

People are now acting on his words. In the rural areas, people who went to work in the city are going back to their land to produce what they need. The hill people and rural farmers are considering ways to become less dependent on the urban markets for rice, cloth, and other goods. The king has encouraged the government to provide infrastructure, such as a water system for the farmers.

People all over Thailand, including the middle classes, also realize that they have to consume less. Some very rich people are perhaps not changing as quickly as we want, but they are changing. In the past, if you carried a handbag with a certain brand name, you would be accepted by society, because your design bag shows your wealth. Now people simply say things like, "Why do you not understand the crisis in our country? Why do you have to import this nonsense?"

Many middle class people in Thailand think that the Asian financial crisis is not necessarily a bad thing. It could be the positive opportunity for everyone to think about what sustainable development means. We cannot deny technology or globalization, but we have to develop our own information and technology. And we have to integrate this development with our spirituality.

Tuenjai Deetes has worked for 16 years with hill tribes in Thailand, co-founded the Hill Area Development Foundation, and received the UN Earth Summit's Global 500 Award.
This text is excerpted from the Spring 1999 issue of "Yes! A Journal of Positive Futures," P.O. Box 10818, Bainbridge Island, Washington, 98110, USA. Internet: www.yes@futurenet.org

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1999 HUMAN DEVELOPMENT REPORT:

Managing Globalization to Enhance Human Lives

Global markets, global technology, global ideas and global solidarity can enrich the lives of people everywhere. The challenge is to ensure benefits are shared equitably and interdependence works for people, not just for profits. This year's Report, published in July, argues that globalization is not new, but that globalization in the present era, driven by competitive global markets, is outpacing the governance of markets and undermining human development.

Markets can go too far and squeeze the non-market activities so vital for human development. Fiscal squeezes are constraining the provision of social services. A time squeeze is reducing the supply and quality of caring labour. And an incentive squeeze is harming the environment.

Globalization is also increasing human insecurity as the spread of global crime, disease and financial volatility outpaces actions to tackle them.

The Report recommends an agenda for action that ranges from reforms for governance with greater equity, to new regional approaches for collective action and negotiations, to national and local policies to capture opportunities in the global marketplace and translate them more equitably into human progress.

The Report also:

- ranks 174 countries on the human development index (HDI)
- provides trends in 79 countries' human development progress from 1975 to 1997
- contains special contributions from Nobel Laureate Amartya Sen on humanizing development; from Paul Streeten on a 10-year perspective of Human Development Reports; and from Ted Turner on the need for partnerships with the United Nations to face new global challenges.

The HDR is available in 10 languages: Arabic, Catalan, English, French, German, Italian, Japanese, Portuguese, Russian and Spanish.

Visit the HDR website at http://www.undp.org/hdro

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RETHINKING THE INTERNATIONAL FINANCIAL SYSTEM:

Views from the South

Open global market.....rapid, massive capital inflows and outflows.....financial meltdown and emergency bail-out.....stalled economic growth. In recent months, this sequence of events has been experienced by several developing countries in different regions. Where national economies have been severely disrupted, could social upheaval yet occur? What about ripple-effects on closely linked or neighbouring countries?

Are there ways to assure a less volatile, more predictable world economy? To this end, can we rethink the international financial system to foster sustainable growth in developing countries as a major engine of global development? In this issue of Cooperation South, six authors and a UN expert committee look at these questions. They offer insights and some possible new approaches from institutional, practical and regional viewpoints:

INSTITUTIONS AND PRACTICES

- **TOWARDS A NEW INTERNATIONAL FINANCIAL ARCHITECTURE.**
  Suggestions for safeguarding the world economy come from the UN Executive Committee on Economic and Social Affairs.
- **INTERNATIONAL MONETARY FUND: A CURE OR A CURSE?**
  Misdirected for many years, IMF prescriptions reflect "an increasingly dilapidated system of global governance," according to Devesh Kapur.
- **BORROWERS, LENDERS AND THE ASIAN FINANCIAL CRISIS: THE "MORAL HAZARD."**
  The recent Asian financial crises were preceded by a false sense of comfort and many hazards, says Aziz Ali Mohammed.

REGIONAL ISSUES

- **POLICY INSTRUMENTS FOR RETURN OF PRIVATE CAPITAL TO ASIAN COUNTRIES.**
  Broader change and reforms, not less, are called for to relieve Asia's economic distress, says Roberto F. De Ocampo.
- **MANAGING FOREIGN CAPITAL FLOWS IN CHILE.**
  As a possible model for other developing countries, Martin Khor and Lean Ka-Min discuss Chilean measures to manage capital movements.
- **GLOBALIZATION OF FINANCE AND DEVELOPMENT PROSPECTS IN AFRICA.**
  Nguyuru Lipumba argues for growth-promoting national actions and more and better international aid for Africa.

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